

# **EXHIBIT 19**



**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO**

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and Required Supplementary Information

June 30, 2016

(With Independent Auditors' Report Thereon)



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OF THE COMMONWEALTH OF PUERTO RICO**  
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## **Independent Auditors' Report**

To the Retirement Board of the Government of Puerto Rico  
Employees' Retirement System of  
the Government of the Commonwealth of Puerto Rico:

We have audited the accompanying financial statements of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System), which comprise the statement of fiduciary net position as of June 30, 2016, the related statement of changes in fiduciary net position for the year then ended, and the related notes to the financial statements, which collectively comprise the System's basic financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditors' Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the fiduciary net position of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico as of June 30, 2016, and the changes in its fiduciary net position for the year then ended, in accordance with U.S. generally accepted accounting principles.



## **Emphasis of Matters**

### *Uncertainty about Ability to Continue as a Going Concern*

The accompanying financial statements have been prepared assuming that the System will continue as a going concern. As discussed in notes 3 and 14 to the basic financial statements, the System is severely underfunded, sold its remaining investments in the aggregate amount of approximately \$297 million, and started operating on a pay as you go basis in fiscal year 2018. Additionally, on May 3, 2017 and May 21, 2017, the Financial Oversight and Management Board for Puerto Rico commenced cases for the Commonwealth of Puerto Rico and the System, respectively, by filing petitions for relief under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act with the United States District Court for Puerto Rico. Accordingly, management of the System has stated that substantial doubt exists about the System's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters are also described in note 3. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

## **Other Matters**

### *Required Supplementary Information*

U.S. generally accepted accounting principles require that the management's discussion and analysis in pages 3 to 15 and the schedules in pages 67 to 70 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standard Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

**KPMG LLP**

San Juan, Puerto Rico  
October 5, 2018

Stamp No. E351461 of the Puerto Rico  
Society of Certified Public Accountants  
was affixed to the record copy of this report.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT  
OF THE COMMONWEALTH OF PUERTO RICO**

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Management's Discussion and Analysis (Unaudited)

June 30, 2016

**Introduction**

The following discussion and analysis of the financial performance of the Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System) provides an overview of its activities for the fiscal year ended June 30, 2016. Its purpose is to provide explanations and insights into the information presented in the basic financial statements and required supplementary information. This discussion and analysis is intended to be read in conjunction with the System's financial statements.

The System is a trust created by the Commonwealth of Puerto Rico (the Commonwealth) in 1951 pursuant to Act No. 447 of May 15, 1951, as amended, to provide pension and other benefits to retired employees of the Commonwealth, its public corporations and municipalities. Prior to August 23, 2017, the System was administered by the Puerto Rico Government Employees' and Judiciary Retirement Systems Administration (the ERS and JRS Administration).

Prior to August 23, 2017, the System administered a cost-sharing, multi-employer pension plan consisting of three benefit structures: (i) a cost-sharing, multi-employer, defined benefit program, (ii) a defined contribution program (the System 2000 program), and (iii) a contributory hybrid program. The System also administered postemployment healthcare benefits provided by the Commonwealth to retired plan members through the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities Medical Insurance Plan Contribution (ERS MIPC).

The System is considered an integral part of the financial reporting of the Commonwealth and is included in the Commonwealth's basic financial statements as a pension trust fund.

**Overview of the Basic Financial Statements**

The following discussion and analysis is intended to serve as an introduction to the System's basic financial statements. The basic financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) as applicable to governmental organization per Governmental Accounting Standards Board (GASB) pronouncements and include the following:

- The Statement of Fiduciary Net Position presents the financial position of the System at fiscal year-end. It provides information about the nature and amounts of resources with present service capacity that the System presently controls (assets), consumption of net assets by the System that is applicable to a future reporting period (deferred outflow of resources), presents obligations to sacrifice resources that the System has little or no discretion to avoid (liabilities), and acquisition of net assets by the System that is applicable to a future reporting period (deferred inflow of resources) with the difference between assets/deferred outflow of resources and liabilities/deferred inflow of resources being reported as net position. Investments are shown at fair value. All other assets and liabilities are determined on an accrual basis.
- The Statement of Changes in Fiduciary Net Position presents the results of activities during the fiscal year. All changes affecting the assets/deferred outflow of resources and liabilities/deferred inflow of resources of the System are reflected on an accrual basis of when the activity occurred, regardless of the timing of the related cash flows. Changes in the fair values of investments are included in the year's activity as net appreciation (depreciation) in fair value of investments.

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- The Notes to the Basic Financial Statements – provide additional information that is essential to a full understanding of the data provided in the financial statements. The notes present information about the System's accounting policies, significant account balances and activities, material risks, obligations, contingencies, and subsequent events, if any.

Required Supplementary Information is presented after the notes to the basic financial statements. Such information, although not a part of the basic financial statements, is required by the GASB. It consists of information pertaining to the System's actuarial methods and assumptions and provides data on changes in the employers' net pension liability and related ratios, the pension benefits employers' contributions, and the pension benefits' investment return as well as data on the System's other postemployment benefits.

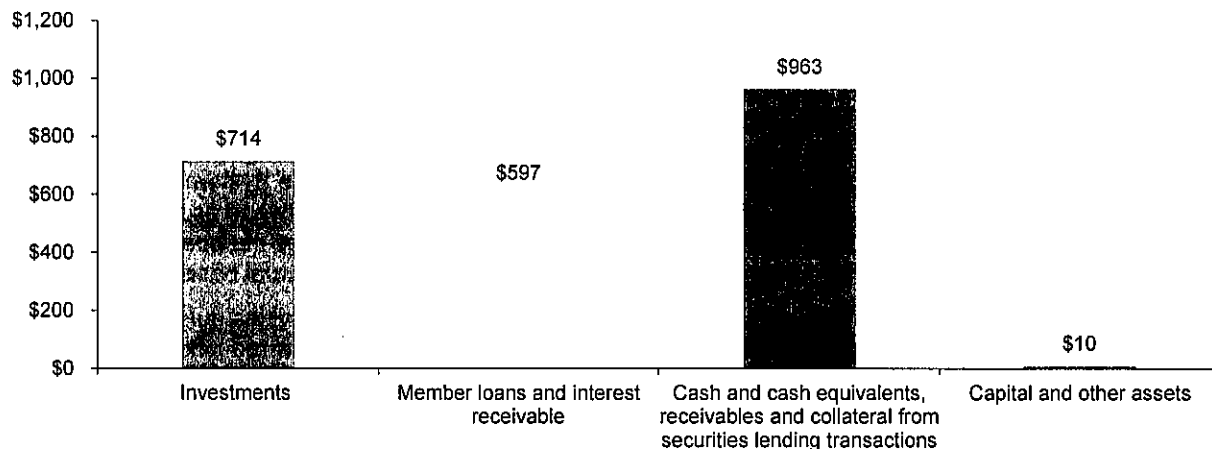
*Financial Highlights*

Prior to August 23, 2017, the System provides retirement benefits to employees of the Commonwealth. The System's total assets as of June 30, 2016 and 2015 amounted to approximately \$2,284 million and \$2,697 million, respectively.

As of June 30, 2016, the System's total assets consisted of the following:

- \$667 million of investments in bonds, stocks and nonexchange commingled trust funds
- \$47 million in investments in limited partnerships
- \$597 million in member loans and interest receivable
- \$963 million in cash and cash equivalents, receivables and collateral from securities lending transactions.
- \$10 million in capital and other assets

The System's total assets as of June 30, 2016 are presented in the following chart (in millions):



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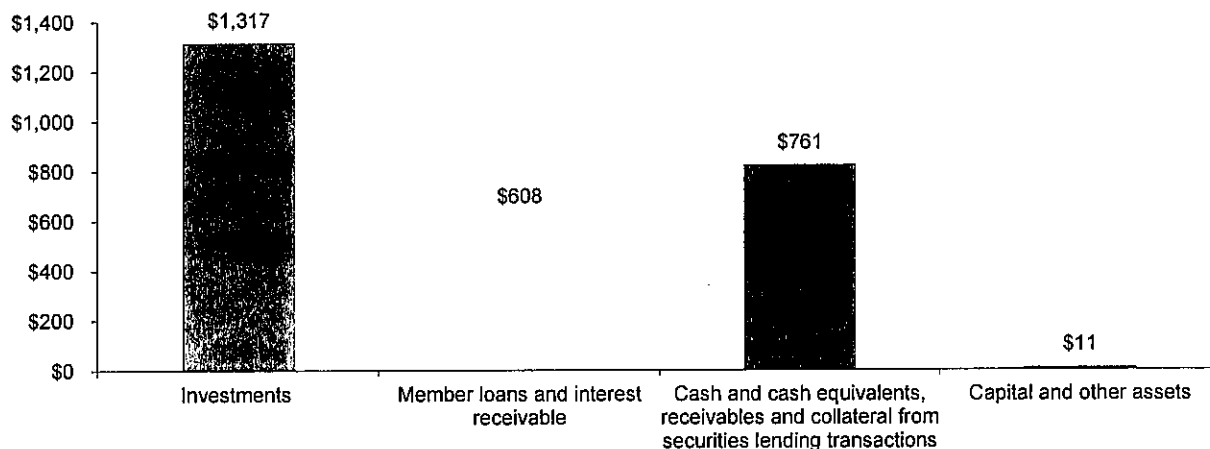
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As of June 30, 2015, the System's total assets consisted of the following:

- \$1,263 million of investments in bonds, stocks and nonexchange commingled trust funds
- \$54 million in investments in limited partnerships
- \$608 million in member loans and interest receivable
- \$761 million in cash and cash equivalents, receivables and collateral from securities lending transactions.
- \$11 million in capital and other assets

The System's total assets as of June 30, 2015 are presented in the following chart (in millions):



- The System has been in a deficit position since fiscal year 2015. The System's total liabilities exceeded total assets, representing a fiduciary net deficit position of approximately \$1,266 million as of June 30, 2016, compared with fiduciary net position of approximately \$668 million as of June 30, 2015.
- The System's fiduciary net deficit position as a percentage of the total pension liability was negative 3.47% at June 30, 2016 and 2.05% at June 30, 2015.
- The ERS MIPC, which constitutes the System's other postemployment healthcare benefits, is financed by the Commonwealth on a pay-as-you-go basis and consequently is unfunded.



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The following schedules present comparative summary financial statements of the System's fiduciary net position and changes in fiduciary net position for fiscal years 2016 and 2015:

**Comparative Summary of Fiduciary Net Position – Pension Benefits**

	<u>2016</u>	<u>2015</u>	<u>Total dollar change</u>	<u>Total percentage change</u>
		(Dollars in thousands)		
<b>Assets:</b>				
Cash and cash equivalents, receivables-net and collateral from securities lending transactions	\$ 962,706	761,235	201,471	26.5 %
Investments	714,214	1,316,611	(602,397)	(45.8)
Member loans and interest receivable – net	596,997	607,617	(10,620)	(1.7)
Capital assets and other	<u>10,487</u>	<u>11,306</u>	<u>(819)</u>	<u>(7.2)</u>
Total assets	<u>2,284,404</u>	<u>2,696,769</u>	<u>(412,365)</u>	<u>(15.3)</u>
<b>Liabilities:</b>				
Accounts payable and accrued liabilities	104,315	9,329	94,986	1,018.2
Bond interest payable	14,094	13,876	218	1.6
Payable for investment securities purchased	1,609	7,754	(6,145)	(79.2)
Securities lending obligations	19,754	80,071	(60,317)	(75.3)
Due to Commonwealth of Puerto Rico	91,474	76,613	14,861	19.4
Escrow funds of mortgage loans and guarantee insurance reserve for loans to plan members	10,467	10,212	255	2.5
Bonds payable	3,134,902	3,105,448	29,454	0.9
Other liabilities	<u>173,673</u>	<u>61,738</u>	<u>111,935</u>	<u>181.3</u>
Total liabilities	<u>3,550,288</u>	<u>3,365,041</u>	<u>185,247</u>	<u>5.5</u>
Net position (deficit)	\$ <u>(1,265,884)</u>	<u>(668,272)</u>	<u>(597,612)</u>	<u>89.4 %</u>

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**Comparative Summary of Changes in Fiduciary Net Position – Pension Benefits**

	<u>2016</u>	<u>2015</u>	<u>Total dollar change</u>	<u>Total percentage change</u>
		(Dollars in thousands)		
Additions:				
Contributions:				
Employer contributions:				
Basic benefits	\$ 582,803	479,911	102,892	21.4 %
Special benefits	196,674	186,136	10,538	5.7
Member contributions	333,633	339,650	(6,017)	(1.8)
Net investment income	37,345	29,258	8,087	27.6
Other income	52,791	28,499	24,292	85.2
Total additions	<u>1,203,246</u>	<u>1,063,454</u>	<u>139,792</u>	<u>13.1</u>
Deductions:				
Benefits paid to participants	1,532,640	1,541,324	(8,684)	(0.6)
Refunds of contributions	34,937	31,351	3,586	11.4
Interest on bonds payable	196,211	194,400	1,811	0.9
General and administrative	27,670	33,623	(5,953)	(17.7)
Other expenses	9,401	11,694	(2,293)	(19.6)
Total deductions	<u>1,800,859</u>	<u>1,812,392</u>	<u>(11,533)</u>	<u>(0.6)</u>
Net decrease in net position	(597,613)	(748,938)	151,325	(20.2)
Net position (deficit):				
Beginning of year	<u>(668,272)</u>	<u>80,666</u>	<u>(748,938)</u>	<u>(928.4)</u>
End of year	\$ <u>(1,265,885)</u>	<u>(668,272)</u>	<u>(597,613)</u>	<u>89.4 %</u>

**Going Concern**

The discussion in note 3 to the financial statements provides information regarding the System's going concern uncertainty.

The System is a mature retirement system with a significant retiree population. The System's net pension liability and fiduciary net deficit position as a percentage of the total pension liability (the funded ratio) as of June 30, 2016, were approximately \$37,699 million and negative 3.47%, respectively. The System has been in a deficit position since fiscal year 2015. Based on statutory funding requirements, the annual benefit payments and administrative expenses paid by the System were significantly larger than the member and employers' contributions to the System. Due to the small asset base, investment income was insufficient to cover the negative cash flow. Illiquid assets (employers' account receivable, net, member loans and related interest

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receivable, COFINA investment and investments in limited partnerships) constituted approximately \$997 million or 44% of the System's total assets as of June 30, 2016. Because of the System's liquidity issues, it may be forced to sell illiquid assets, specifically member loans, potentially at significant loss to further detriment of the System.

As described in notes 3 and 14 to the basic financial statements, in July 2017, the System sold investments amounting to approximately \$297 million and began operating on a "pay as you go" basis.

The System's funding requirements, together with the funding requirements of the Retirement System for the Judiciary of the Commonwealth of Puerto Rico (JRS) and the Puerto Rico System of Annuities and Pensions for Teachers (TRS, and collectively with the System and JRS, the Retirement Systems), could have a negative effect on the General Fund of the Commonwealth (the General Fund) because the Commonwealth is the primary sponsor and is obligated to make contributions to fund each of the Retirement Systems.

The Commonwealth and the other participating employers have faced significant fiscal and economic challenges in recent years due, among other factors, to continued budget deficits, a prolonged economic recession, high unemployment rate, population decline, and high levels of debt and pension obligations. The June 30, 2015 financial statements of the Commonwealth disclosed that there is substantial doubt about the Commonwealth ability to continue as a going concern.

On June 30, 2016, the U.S. Congress enacted the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which automatically put into effect a temporary stay of all debt-related litigation against the Commonwealth and its covered instrumentalities, including the System. On May 1, 2017, the PROMESA stay expired, permitting substantial litigation to resume against the Commonwealth and its covered instrumentalities. On May 3, 2017, the Financial Oversight and Management Board for Puerto Rico (the Oversight Board), at the request of the Commonwealth, commenced a Title III case for the Commonwealth by filing a petition for relief under Title III of PROMESA in the District Court for the District of Puerto Rico. On May 21, 2017, the Oversight Board, at the request of the System, commenced a Title III case for the System by filing a similar petition for relief under Title III of PROMESA.

On August 23, 2017, the Commonwealth enacted the Act to Guarantee the Payment to Our Pensioners and Establish a New Plan for Defined Contributions for Public Servants (Act No. 106 of 2017), which reformed the Commonwealth's pensions by, among other things, replacing the governing boards of the System, JRS, and TRS with a single Retirement Board of the Government of Puerto Rico (the Retirement Board) and established a separate "Account for the Payment of Accrued Pensions" to implement a "pay-as-you-go" (PayGo) method for the payment of pensions. Act No. 106 of 2017 created the legal framework so that the Commonwealth can make payments to pensioners through the PayGo system.

**Comparative Summary of Fiduciary Net Position Analysis – Pension Benefits**

The basic financial statements of the System for the fiscal year ended June 30, 2016, present a decrease in net position of approximately \$598 million, resulting in a net deficit position of approximately \$1,266 million as of June 30, 2016, compared with a net position of approximately \$668 million as of June 30, 2015. The decrease in the net position (increase in deficit) in fiscal year 2016 resulted from excess deductions (mainly consisting of benefits paid to participants) over additions (mainly consisting of contributions from participating employers and

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employees). The decrease in net position is primarily caused by a decrease in investments of approximately \$602 million in fiscal year 2016.

Total contributions from participating employers and members increased by approximately \$107 million, from \$1,005 million during fiscal year 2015 to approximately \$1,113 million during fiscal year 2016. Total net investment and securities lending transaction income increased by approximately \$8 million, from approximately \$29 million during fiscal year 2015 to approximately \$37 million during fiscal year 2016. The System recognized a net appreciation in the fair value of investments of approximately \$870,000 during 2016, compared with a net depreciation in the fair value of investments of approximately \$46 million recognized in 2015. In addition, the System recognized an impairment loss on deposits with a governmental bank of approximately \$21 million in fiscal year 2016. For additional information regarding the System's investments and securities lending transactions, refer to note 6.

Total deductions decreased by approximately \$12 million in fiscal year 2016, mainly as a result of the decrease of approximately \$9 million in benefits paid to participants and the decrease of approximately \$6 million in general and administrative expenses. The total aggregate amount of benefits paid to participants was approximately \$1,533 million for fiscal year 2016, as compared to approximately \$1,541 million for fiscal year 2015. General and administrative expenses were approximately \$28 million for fiscal year 2016, as compared to approximately \$34 million for fiscal year 2015.

During fiscal year 2007, the Board of Trustees approved the issuance of bonds payable to increase the funds available to pay pension benefits to certain beneficiaries and to reduce the unfunded accrued actuarial liability. As of June 30, 2016, the total aggregate amount of outstanding bonds payable was approximately \$3,135 million.

**Other Postemployment Healthcare Benefits**

Other postemployment healthcare benefits paid during fiscal year 2016 under the ERS MIPC amounted to approximately \$94 million, a decrease of approximately \$3 million or 3.7% as compared to the approximately \$97 million paid during fiscal year 2015. Effective July 1, 2013, no benefits are provided to new retirees, as required under Act No. 3.

**Financial Analysis of the System**

As of June 30, 2016 and 2015, the System held approximately \$597 million and \$608 million, respectively, in loans and interest receivable from plan members, which represents 46% and 32%, respectively, of the total investment portfolio, including loans. As of June 30, 2016, member loans and interest receivable consisted of \$170 million in mortgage loans, \$351 million in personal loans, \$45 million in cultural trips loans, and \$34 million in interest receivable, less \$3 million in allowance for adjustments and losses in realization. As of June 30, 2015, member loans and interest receivable consisted of \$171 million in mortgage loans, \$360 million in personal loans, \$41 million in cultural trips loans, and \$37 million in interest receivable, less \$2 million in allowance for adjustments and losses in realization. As of June 30, 2016 and 2015, the fair value of the System's investment in limited partnerships was approximately \$47 million, which represented approximately 4% and 3% of the investment portfolio, as of June 30, 2016 and 2015, respectively.

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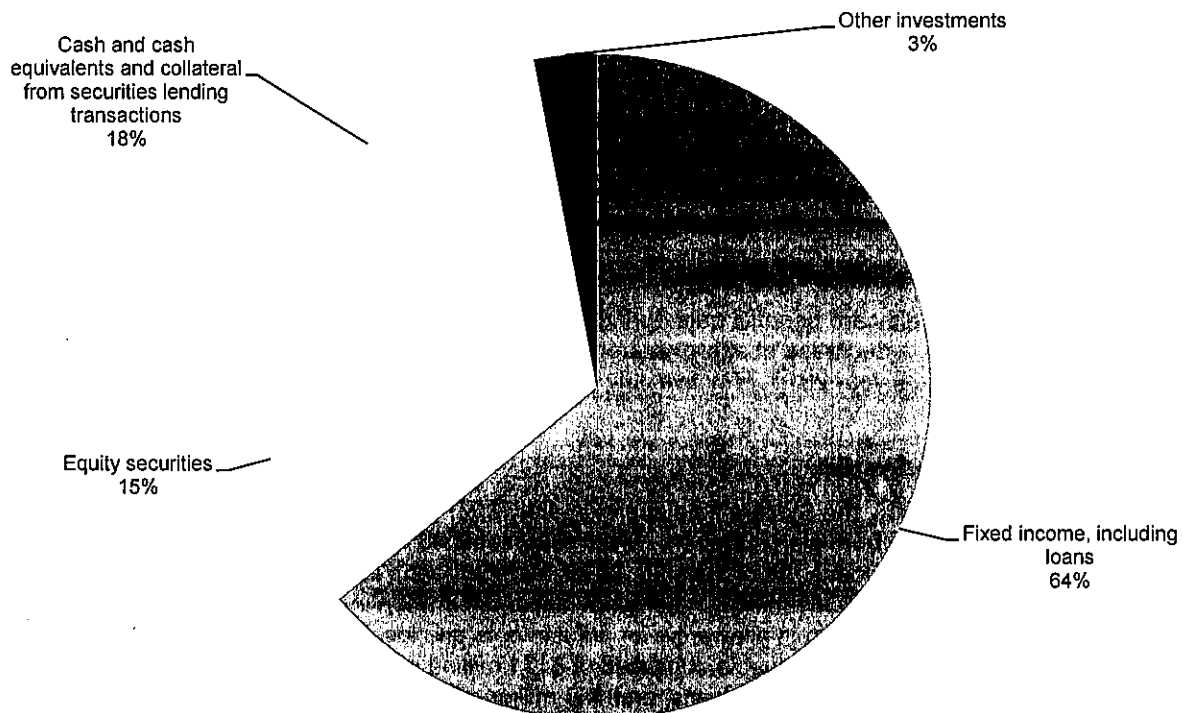
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The System earns additional investment income by lending investment securities to brokers via its custodian's securities lending program. The brokers provide collateral to the System and generally use the borrowed securities to cover short sales and failed trades. The cash collateral received from the brokers is invested in a short-term investment fund in order to earn interest. For the fiscal years ended June 30, 2016 and 2015, net income from the securities lending activity amounted to approximately \$113,000 and \$165,000, respectively.

**Investment Portfolio and Capital Markets Overview**

The System's total investment assets, including member loans, collateral from securities lending transactions and cash and cash equivalents (investment portfolio, including loans), as of June 30, 2016 totaled approximately \$1,985 million. Member loans amounted to \$597 million as of June 30, 2016.

As of June 30, 2016, the System's investment portfolio allocation, including member loans, was 64% in fixed-income investments, including loans receivable, 15% in equity securities, 18% in cash and short-term investments, and 3% in other investments as shown in the following chart:



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*Economy and Capital Markets Overview*

The relatively benign market conditions in late 2015 were merely a pleasant pause in an otherwise challenging market environment, characterized by uncertainty and volatility. Volatile market action and overall risk-off mentality remained as the global financial markets wrestled with fragile global economic growth, central bank actions, currency volatility, weak energy/commodity prices, geopolitical concerns and the U.S. Presidential election. After a generally positive start to the second quarter 2016, uncertainty and volatility returned by quarter end. Among the major developments were the unexpected Brexit vote and the continued slide of global bond yields.

In this environment, currency volatility increased, particularly surrounding the Brexit vote, leaving the U.S. dollar with mixed results. Commodity prices extended their recent gains. During the recent quarter, the U.S. dollar increased relative to the British pound and euro. Alternatively, the Japanese yen rallied over 9.0% versus the dollar, and many emerging market currencies also advanced. Global commodity prices trended higher pushing the Bloomberg (formerly known as DJUBS) Commodity Total Return index up over +12.0%, led by energy prices. Crude oil (WTI) prices rose about 26% back over the \$50 mark during June but finished the quarter at \$48. Natural gas prices also shot up late in the quarter. Benefitting from the increased uncertainty, gold prices extended their gains, rising about 7.2%.

Global equity markets were mixed in the second quarter. The ACWI ex U.S. index was down 0.6% in U.S. dollar terms (0.1% local) and is down 1.0% (-4.1% local) for the year to date. Led by Latin American countries, the MSCI Emerging Markets index finished the quarter about 0.7% higher. In the U.S. markets, the S&P 500 increased 2.5% including dividends, raising the year-to-date return to 3.8%. For the quarter, the best performing sectors (S&P 500) were more yield-oriented – Energy, Telecom and Utilities. REITs were up over 13.5% through June 30, 2016. Small cap stocks outperformed. The Russell 2000 Index posted a quarterly gain of 3.8%, returning to positive territory for the year through June 30, 2016, while the NASDAQ decreased 1.1% lowering its year-to-date return to -3.2%. Value significantly outperformed for the quarter and the year to June 30, 2016.

As noted above, global bond yields further declined during the quarter. As of June 30, 2016, the U.S. 10-year Treasury yield decreased by approximately 28 basis points to 1.5%. The Barclays Aggregate Bond index added 2.2% for the quarter, resulting in a 5.3% gain for the year to date. Government bond yields in Europe also extended their slide with even the German bund yield dipping into negative territory. Credit spreads narrowed in the U.S. markets as the high yield sector rallied led by the energy complex which rebounded by double-digits. The BoAML U.S. High Yield index increased 5.9% raising the year-to-date return to 9.3%. The S&P/LTSA Leveraged Loan index increased 2.9%.

*Industry Indices Performance Overview*

**Total Fund Performance**

The System's total investment portfolio, including member loans, returned 2.8% while total investments, excluding loans returned 3.4% during the 2016 fiscal year, modestly underperforming its policy benchmark by 0.6% points. Underperformance was primarily due to an underweight allocation to domestic equities relative to the long-term target weights.

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*United States Equity Overview for the Fiscal Year 2016*

The System's domestic equity component returned 3.7% during the fiscal year, outperforming its benchmark, the Russell 3000 Index Fund, by 0.1 percentage points. Outperformance was due to the impact of cash flow timing and withdrawals. The Russell 3000 Index Fund matched its benchmark during the period. Approximately \$175 million was redeemed from the domestic equity component during the fiscal year in order to meet the cash needs of the System. As of June 30, 2016, the total amount of the System's domestic equity assets was \$160 million and represented approximately 11% of the System's total investment portfolio, including member loans.

*International Equity Overview for the Fiscal Year 2016*

International equities, as measured by the MSCI ACW ex-U.S. Index, returned negative 1%. Developed international equities returned negative 0.8% as measured by the MSCI EAFE Index. Japan was the strongest performing region during the period. Emerging market equities as represented by the MSCI Emerging Markets Index returned 1.2%.

During the fiscal year ended June 30, 2016, the System's international equity component returned negative 0.8%, outperforming its benchmark by 0.2% points. Outperformance was due to modest positive tracking error during the period. Approximately \$49.0 million was redeemed from the component during the fiscal year in order to meet the cash needs of the System. At the end of the fiscal year, the component had approximately \$59.2 million in assets, representing 4% of the System's total investment portfolio, including member loans.

*United States Fixed Income Overview for the Fiscal Year 2016*

The broad U.S. fixed income market, as measured by the Barclays Aggregate Bond Index, returned 4.9% during the period. The Barclays Intermediate Credit Index, the System's benchmark for its fixed income portfolio, slightly trailed the broader U.S. fixed income market and returned 4.9%. All underlying sectors generated positive returns during the period, with the government bond and mortgage backed securities sectors providing the strongest returns. Longer duration bonds outperformed shorter duration bonds, while higher quality maturities outpaced those of lower quality.

The System's fixed income component gained 5.2% during the fiscal year ended June 30, 2016, modestly outperforming its benchmark by 0.3 percentage points. Chicago Equity Partners was the only outperforming manager, while Mesirow, Taplin Canida & Habacht, Popular, Santander and Barrow Hanley detracted from results. The SSGA Intermediate Credit Index Fund matched its benchmark during the period. At the end of the fiscal year, fixed income investment portfolio assets totaled approximately \$361.2 million, consisting of approximately 24.1% of the System's total investment portfolio, including member loans. Approximately \$553 million was redeemed from the component during the fiscal year in order to meet the cash needs of the System.

*Other Investments and Member Loans Transactions*

As of June 30, 2016, the System held approximately \$597 million in member loans, which represented 40% of the total investment portfolio, including loans. Member loan balances as of June 30, 2016 were \$11 million lower than the prior year.



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At the end of fiscal year 2016, the System had some exposure to limited partnerships of private equity investments valued at approximately \$48 million, which represented 3.4% of the System's total investment portfolio, including member loans.

In order to cover its deficiency of Commonwealth's employee and employer contributions under benefit payments to participants, the System liquidated part of its investment portfolio and transferred approximately \$637 million to the Commonwealth in fiscal year 2016.

**Funding Status**

The System was created under Act No. 447 in 1951 and, since its inception, has lacked proper planning. Contribution levels were relatively low and remain low in comparison to the level of benefits. As more people joined the government labor force and then retired under the System's various benefit structures, the gap between the assets available to pay benefits and the actuarial obligation started to increase.

During 2007, in an effort to increase the funds available to pay pension benefits and to reduce the unfunded accrued actuarial pension liability, the System authorized the issuance of one or more series of bonds (the Bonds). As a result of these issuances, the System pledged future employers' contributions to the payment of the Bonds, invested the proceeds of the Bonds, and used those investments and the earnings thereon to provide pension benefits to beneficiaries. Specifically, on January 31, 2008, the System issued the first series of Bonds, which consisted of approximately \$1,589 million aggregate principal amount of Senior Pension Funding Bonds, Series A. On June 2, 2008, the System issued the second of such series of Bonds, which consisted of approximately \$1,059 million aggregate principal amount of Senior Pension Funding Bonds, Series B. Finally, on June 30, 2008, the System issued the third and final of such series of Bonds, which consisted of approximately \$300 million aggregate principal amount of Senior Pension Funding Bonds, Series C.

Despite these efforts, the System's actuarial obligation continued its upward trend as a result of the continuous increase in the number of covered pensioners and the higher salaries of incoming pensioners, which resulted in even higher annuities under Act No. 447. The bottom line is that the capital markets alone cannot solve the System's funding problem.

Additionally, the Commonwealth has enacted a series of laws to deal with the funding issues that the System has experienced. For example, in 2011, the Commonwealth enacted Act No. 116, which increased the employers' contribution rate from 9.275% to 10.275% of employee compensation for the 2011-2012 fiscal year, 1% annually for each of the next four years, and 1.25% annually for each of the five years thereafter, reaching an aggregate contribution rate of 20.525% effective July 1, 2020. Other measures taken to improve the System's funding, included: (1) improving the collection of late contributions by receiving such contributions directly from the Municipal Revenue Collection Center (known as CRIM by its Spanish acronym) when a municipality fails to send their contributions within 30 days from the due date or from the Department of Treasury of the Commonwealth in the case of public corporations; (2) implementing Act No. 70, which established early retirement incentives; (3) revising the Employee Personal Loan Policy by reducing personal and cultural loan amounts to \$5,000 each, from \$15,000 and \$10,000, respectively; and (4) receiving approximately \$162.5 million in bonds issued by the Puerto Rico Sales Tax Financing Corporation (known as COFINA by its Spanish acronym).



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In 2013, the Commonwealth enacted Act No. 3 that reformed the System by, among other measures, reducing benefits, increasing employee contributions, and, in the case of active employees who were entitled to the defined benefits program, replacing most of the defined benefit elements of the system with a defined contribution system. Based on the statutory funding requirements prior to this reform, the annual benefit payments and administrative expenses of the System were significantly larger than the member and employer contributions made to the System.

Act No. 3 amended Act No. 447, Act No. 1 of 1990 (Act No. 1) and Act No. 305 (collectively, the ERS Acts) to establish, among other things, a defined contribution program similar to the System 2000 program (the Contributory Hybrid Program) to be administered by the System. All regular employees hired for the first time on or after July 1, 2013, became part of the Contributory Hybrid Program. Also, Act No. 3 froze all retirement benefits accrued through June 30, 2013 under the Defined Benefit Program, and thereafter, all future benefits accrued under the defined contribution formula used for the 2000 System participants. Ceasing future defined benefit accruals under Act No. 447 and Act No. 1 and converting to a member-funded hybrid plan will result in lower benefit payments as these tiers wind down and will make all future employer contributions available to pay benefits and bonds payable debt service.

On June 27, 2017, the Treasury Department issued Circular Letter No. 1300-46-17 in order to convey to central government agencies, public corporations and municipalities the new implementation procedures to adopt, effective July 1, 2017, a new "pay-as-you-go" (PayGo) mechanism for the System. With the start of fiscal year 2018, employers' contributions, contributions ordered by special laws, and the Additional Uniform Contribution were all eliminated. The System will determine and administer the payment amount per retiree that will be charged to each agency, public corporation and municipality.

In addition to the establishment of the PayGo mechanism, Act No. 106, reformed the Commonwealth's Retirement Systems so that their active participants would deposit their individual contributions in a new Defined Contributions Plan that will be managed by a private entity. Act No. 106 created the legal framework so that the Commonwealth can make payments to pensioners through the PayGo system. Approximately \$2 billion was allocated for these purposes in each of the budgets for fiscal year 2018 and fiscal year 2019. Act No. 106 also created a Defined Contributions Plan, similar to a 401(k) plan, which requires contributions from public servants because future benefits will not be paid by the Retirement Systems.

As of June 30, 2016, the System's pension plan consisted of three different benefit structures, which are administered according to their specifications in each ERS Act. For all plan members, employee contributions range from 8.275% to 10% of the employee salary, as specified by the employee. Under all structures, employers' contributions during the year ended June 30, 2016 were 13.275% of the employee salary. Based on the last actuarial valuation as of June 30, 2016, the total amount of the employers' net pension liability was approximately \$37,660 million, with the pension plan's fiduciary net deficit position as a percentage of the total pension liability of negative 3.37%. The liability for postemployment healthcare benefits under ERS MIPC amounted to approximately \$1,349 million as of June 30, 2016 and was fully unfunded.

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**Capital Assets**

The total aggregate amount of the System's investment in capital assets (net of accumulated depreciation) was approximately \$9.7 million and \$10.5 million as of June 30, 2016 and June 30, 2015, respectively. Capital assets include land, buildings and improvements, construction in progress, and equipment. Buildings and improvements consist of the facilities in which the System conducts its operations.

**Debt Administration**

Long-term debt obligations include the System's senior bonds in the aggregate principal amount of approximately \$3,135 million and \$3,105 million as of June 30, 2016 and June 30, 2015, respectively. The System has issued three series of revenue Bonds designated as "Senior Pension Funding Bonds", the proceeds of which have been used mainly to increase the funds currently available to pay pension benefits to certain of its beneficiaries and reduce its unfunded actuarial accrued liability. The Bonds are limited, nonrecourse obligations of the System, payable solely from and secured solely by a pledge of employer contributions made after the date of issuance of the first series of Bonds, and from funds held on deposit with the Bank of New York Mellon (the Fiscal Agent). The Bonds are not payable from contributions made to the System by participating employees, or from the assets acquired with the proceeds of the Bonds, or from employer contributions released by the Fiscal Agent to the System after funding of required reserves, or from any other assets of the System. These bonds are currently rated "C" by Moody's Investors Service and "CC" by Standard & Poor's Ratings Services. For additional information regarding the System's long-term obligations, refer to note 10. For additional information regarding the suspension of the monthly payments to the trustee of the System's bonds in July 2016 and other subsequent events, refer to note 14.

**Requests for Information**

This financial report is designed to provide a general overview of the System's finances, comply with related laws and regulations, and demonstrate commitment to public accountability. Questions concerning any of the information provided in this report or requests for additional information should be addressed to the Commonwealth of Puerto Rico Government Employees and Judiciary Retirement Systems Administration, Avenida José de Diego, Parada 22 Centro Gubernamental Minillas Edificio Torre Norte, Piso 11, San Juan, Puerto Rico, 00940.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT  
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Statement of Fiduciary Net Position

June 30, 2016

(In thousands)

	<u>Pension</u>	<u>Post employment healthcare benefits</u>	<u>Total</u>
<b>Assets:</b>			
Cash and cash equivalents:			
Deposits with Government Development Bank for Puerto Rico (GDB):			
Unrestricted	\$ 162,324	—	162,324
Restricted	48,441	—	48,441
Deposits at commercial banks:			—
Unrestricted	242,779	—	242,779
Restricted	12,608	—	12,608
Money market funds:			
Unrestricted	59,361	—	59,361
Restricted	126,528	—	126,528
U.S. Treasury bill – restricted	170	—	170
Total cash and cash equivalents	<u>652,211</u>	<u>—</u>	<u>652,211</u>
Receivables, net:			
Employers – net of allowance for uncollectible accounts of \$250,834	258,801	—	258,801
Due from Retirement System for the Judiciary of the Commonwealth of Puerto Rico	7,854	—	7,854
Investments sold	738	—	738
Accrued investment income	8,348	—	8,348
Other	15,000	—	15,000
Total receivables, net	<u>290,741</u>	<u>—</u>	<u>290,741</u>
Collateral from securities lending transactions	19,754	—	19,754
Investments:			
Bonds and notes	445,891	—	445,891
Nonexchange commingled trust funds	219,585	—	219,585
Investments in limited partnerships	47,461	—	47,461
Stocks	1,277	—	1,277
Total investments	<u>714,214</u>	<u>—</u>	<u>714,214</u>
Member loans and interest receivable – net	596,997	—	596,997
Capital assets – net	9,733	—	9,733
Other assets	754	—	754
Total assets	<u>2,284,404</u>	<u>—</u>	<u>2,284,404</u>

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Statement of Fiduciary Net Position

June 30, 2016

(In thousands)

	<u>Pension</u>	<u>Post employment healthcare benefits</u>	<u>Total</u>
Liabilities:			
Accounts payable and accrued liabilities	\$ 104,315	—	104,315
Bond interest payable	14,094	—	14,094
Payable for investment securities purchased	1,609	—	1,609
Securities lending obligations	19,754	—	19,754
Due to Commonwealth of Puerto Rico	91,474	—	91,474
Escrow funds of mortgage loans and guarantee insurance reserve for member loans	10,467	—	10,467
Bonds payable	3,134,902	—	3,134,902
Other liabilities	173,674	—	173,674
Total liabilities	3,550,289	—	3,550,289
Contingencies (note 13)			
Unrestricted net deficit position	\$ (1,265,885)	—	(1,265,885)

See accompanying notes to basic financial statements.

**EMPLOYEES' RETIREMENT SYSTEM OF THE GOVERNMENT  
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Statement of Changes in Fiduciary Net Position

Year ended June 30, 2016

(In thousands)

	<u>Pension</u>	<u>Post employment healthcare benefits</u>	<u>Total</u>
Additions:			
Contributions:			
Employer contributions:			
Basic benefits, net of provision for uncollectible contributions of \$40,085	\$ 582,803	—	582,803
Special benefits	196,674	93,728	290,402
Member contributions	333,633	—	333,633
Total contributions	<u>1,113,110</u>	<u>93,728</u>	<u>1,206,838</u>
Investment income:			
Net appreciation in fair value of investments	870	—	870
Impairment loss on deposits with governmental bank (note 6)	(20,935)	—	(20,935)
Interest	59,651	—	59,651
Dividends	277	—	277
Less investment expense, other than from securities lending	<u>(2,631)</u>	<u>—</u>	<u>(2,631)</u>
Net income from investing, other than from securities lending	<u>37,232</u>	<u>—</u>	<u>37,232</u>
Securities lending income	113	—	113
Less securities lending expenses	<u>—</u>	<u>—</u>	<u>—</u>
Net income from securities lending	<u>113</u>	<u>—</u>	<u>113</u>
Net investment income	<u>37,345</u>	<u>—</u>	<u>37,345</u>
Other income	<u>52,791</u>	<u>—</u>	<u>52,791</u>
Total additions	<u>1,203,246</u>	<u>93,728</u>	<u>1,296,974</u>
Deductions:			
Benefits paid to participants:			
Annuities	1,322,408	—	1,322,408
Special benefits	196,674	93,728	290,402
Death benefits	13,558	—	13,558
Refunds of contributions	34,937	—	34,937
Interest on bonds payable	196,211	—	196,211
General and administrative	27,670	—	27,670
Other expenses	<u>9,401</u>	<u>—</u>	<u>9,401</u>
Total deductions	<u>1,800,859</u>	<u>93,728</u>	<u>1,894,587</u>
Net decrease in net position	<u>(597,613)</u>	<u>—</u>	<u>(597,613)</u>
Net position (deficit):			
Beginning of year	<u>(668,272)</u>	<u>—</u>	<u>(668,272)</u>
End of year	\$ <u>(1,265,885)</u>	<u>—</u>	<u>(1,265,885)</u>

See accompanying notes to basic financial statements.

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**(1) Organization**

The Employees' Retirement System of the Government of the Commonwealth of Puerto Rico (the System) is a trust created by the Legislature of the Commonwealth of Puerto Rico (the Commonwealth) pursuant to Act No. 447 on May 15, 1951 (Act No. 447), as amended, to provide pension and other benefits to retired employees of the Commonwealth, its public corporations and municipalities. Prior to August 23, 2017, the System administered a cost-sharing, multi-employer, pension plan (the pension plan). The System also administers post-employment healthcare benefits provided by the Commonwealth to retired plan members (the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities Medical Insurance Plan Contribution – ERS MIPC), an unfunded, cost-sharing, multi-employer defined benefit other postemployment benefit plan.

The System is considered an integral part of the Commonwealth's financial reporting entity and is included in the Commonwealth's basic financial statements as a pension trust fund. The System is a governmental retirement plan and as such is excluded from the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). Income earned by the System is not subject to Federal and Puerto Rico taxes.

Pursuant to Act No. 447, the System was governed by an 11-member board of trustees (the Board of Trustees), composed of (i) the following ex-officio members (or their designees): the Secretary of Treasury of the Commonwealth, the President of the Government Development Bank for Puerto Rico (GDB), the Commissioner of Municipal Affairs, and the Director of the Office of Human Resources of the Commonwealth; (ii) three members appointed to three-year terms by the Governor of the Commonwealth (the Governor), two of whom had to be members of the System and one member of Retirement System for the Judiciary of the Commonwealth of Puerto Rico (JRS), each with at least ten years of credited service; (iii) two members who had to be pensioners of the System and JRS; (iv) the President of the Federation of Mayors; and (v) the President of the Association of Mayors. As of June 30, 2016, the System was governed by the Board.

On August 23, 2017, Act No. 106 replaced the Board with a new Retirement Board of the Government of Puerto Rico (the Retirement Board), which governs all of the Commonwealth's Retirement Systems. The Retirement Board is comprised of 13 members, of (i) the following ex-officio members (or their designees): the Executive Director of the Puerto Rico Fiscal Agency and Financial Advisory Authority (FAFAA); the Secretary of Treasury of the Commonwealth, the Director of the Office of Management and Budget, the Director of the Office for the Administration and Transformation of Human Resources of the Government of Puerto Rico, the President of the Federation of Mayors, and the President of the Association of Mayors; (ii) three Governor-appointed representatives of the teachers of the Department of Education, the public corporations, and the Judiciary Branch; and (iii) four additional Governor-appointed members as representatives of the public interest. As of the date of these financial statements, there are three vacancies on the Retirement Board. For additional information on Act No. 106, refer to note 12.

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Prior to August 23, 2017, the System and JRS, also a component unit of the Commonwealth, were both administered by Puerto Rico Government Employees and Judiciary Retirement Systems Administration (the ERS and JRS Administration (the ERS and JRS Administration). The ERS and JRS Administration allocated 97.93% of its general and administrative expenses to the System during the year ended June 30, 2016. The methodology used to determine the allocation is based on total employer's and participating employees' contributions to the System, divided by the aggregate total of employers' and participating employees' contributions to the System and JRS, combined.

**(2) Summary of Significant Accounting Policies**

The following are the significant accounting policies followed by the System in the preparation of its financial statements:

**(a) Basis of Presentation**

The accompanying financial statements have been prepared on the accrual basis of accounting in accordance with U.S. generally accepted accounting principles (GAAP) as applicable to governmental organizations per the Governmental Accounting Standards Board (GASB) pronouncements. Plan member contributions are recognized in the period in which the contributions are due. Employer contributions are recognized when due and the employer has legal requirement to provide the contributions. Benefits and refunds are recognized when legally due and payable.

**(b) Use of Estimates**

The preparation of the basic financial statements requires management to make significant estimates and assumptions relating to the reporting of assets and liabilities and in the disclosures of contingencies to prepare these financial statements in conformity with GAAP. The System's most significant estimates relate to the total pension liability, and the valuation of certain investments. Due to the inherent nature of these estimates, actual results could differ from those estimates.

**(c) Cash and Cash Equivalents**

Cash equivalents include all highly liquid debt instruments with original maturities of three months or less from the date of acquisition and consist of money market funds, U.S. Treasury bill, and certificates of deposit in GDB (a component unit of the Commonwealth) and in commercial banks. Restricted cash deposited with GDB consists of payments received from mortgage loan holders in the servicing of loans (escrow accounts), expired checks not claimed by the plan members restricted for repayments, and temporary amounts to be transferred to the Bank of New York Mellon (trustee) restricted for bond debt service requirements. Restricted money market funds consist of funds held by the trustee to maintain the debt service funds and the sinking funds for the repayment of the System's bonds payable.

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**(d) Investments**

Investments are reported at fair value. The fair value of investments is based on quoted prices, if available. The System has investments in limited partnerships and nonexchange commingled trust funds valued at approximately \$47 million and \$220 million, respectively, as of June 30, 2016. Fair values of investments in limited partnerships have been estimated in the absence of readily determinable fair values, based on information provided by the underlying fund managers. Nonexchange commingled trust funds are reported at their net asset value (NAV). The NAV includes the market value of the securities in the fund plus any receivables, payables, and accrued fund expenses.

Securities purchases and sales are recorded on a trade-date basis. Realized gains and losses from the sale of securities and unrealized changes in the fair value of outstanding securities are included in net appreciation (depreciation) in fair value of investments. Realized gains and losses are computed as the difference between the proceeds of the sale and the cost of the investment sold, determined by the average cost method. Interest income is recorded as earned on an accrual basis. Dividend income is recorded on the ex-dividend date.

**(e) Member Loans**

Mortgage, personal, and cultural trip loans to plan members are stated at their outstanding principal balance less an allowance for uncollectible amounts. The maximum amount that was loaned to plan members for mortgage loans is \$100,000 and \$5,000 for personal, and cultural trip loans.

The System services mortgage loans with aggregate principal balances of approximately \$170 million as of June 30, 2016, related to certain mortgage loans sold to the Federal National Mortgage Association for a fee of 0.25%. The sale contract stipulates that the System must repurchase any loans with payments in arrears over 90 days.

**(f) Guarantee Insurance Reserve for Member Loans**

Premiums collected and benefits claimed are recorded as additions and deductions, respectively. The guarantee insurance reserve for life insurance on member loans is revised each year and adjusted accordingly based on the annual higher claim amount of a five-year period increased by a management determined percentage.

**(g) Capital Assets**

Capital assets include building, building improvements, and furniture and equipment. The System defines capital assets as assets with an initial individual cost of \$500 or more at the date of acquisition and a useful life equal to or in excess of four years. Capital assets are recorded at historical cost, or their estimated historical cost, if actual historical costs are not available. Donated capital assets are recorded at their estimated fair value at time of donation.



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Capital assets are depreciated on the straight-line method over the assets estimated useful life. There is no depreciation recorded for construction in progress. The estimated useful lives of capital assets are as follows:

	<u>Years</u>
Building	50
Buildings improvements	10
Equipment, furniture, fixtures, and vehicles	5-10

**(h) Termination Benefits**

The System accounts for termination benefits in accordance with GASB Statement No. 47, *Accounting for Termination Benefits*. Pursuant to the provisions of GASB Statement No. 47, the System, as an employer, should recognize a liability and expense for voluntary termination benefits (for example, early retirement incentives) when the offer is accepted and the amount can be estimated. A liability and expense for involuntary termination benefits (for example, severance benefits) should be recognized when a plan of termination has been approved by those with the authority to commit the government to the plan, the plan has been communicated to the employees, and the amount can be estimated.

**(i) Recently Issued Accounting Pronouncements**

The following new accounting standards have been issued but were not effective during the fiscal year ending June 30, 2016:

- GASB Statement No. 74, *Financial Reporting for Postemployment Benefit Plans Other than Pension Plans*. This Statement replaces Statements No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, as amended, and No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. It also includes requirements for defined-contribution other postemployment benefit (OPEB) plans that replace the requirements for those OPEB plans in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, as amended, Statement No. 43, and Statement No. 50, *Pension Disclosures*. The scope of this Statement includes OPEB plans – defined benefit and defined contribution – administered through trusts that meet the following criteria:
  - Contributions from employers and nonemployer contributing entities to the OPEB plan and earnings on those contributions are irrevocable.
  - OPEB plan assets are dedicated to providing OPEB to plan members in accordance with the benefit terms.
  - OPEB plan assets are legally protected from the creditors of employers, nonemployer contributing entities, and the OPEB plan administrator. If the plan is a defined benefit OPEB plan, plan assets also are legally protected from creditors of the plan members.

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This Statement also includes requirements to address financial reporting for assets accumulated for purposes of providing defined-benefit OPEB through OPEB plans that are not administered through trusts that meet the specified criteria. The provisions of this statement are effective for fiscal years beginning after June 15, 2016. The System is evaluating the impact of this new statement.

- GASB Statement No. 82, *Pension Issues – an Amendment of GASB Statements No. 67, No. 68 and No. 73*. This Statement addresses certain issues that have been raised with respect to GASB Statements No. 67, No. 68, and No. 73. The Statement is designed to improve consistency in the application of the pension standards by clarifying or amending related areas of existing guidance. Specifically, this Statement addresses issues regarding (1) the presentation of payroll-related measures in required supplementary information, (2) the selection of assumptions and the treatment of deviations from the guidance in an Actuarial Standard of Practice for financial reporting purposes, and (3) the classification of payments made by employers to satisfy employee (plan member) contribution requirements. Prior to the issuance of this Statement, GASB Statements No. 67 and No. 68 required presentation of covered-employee payroll, which is the payroll of employees that are provided with pensions through the pension plan, and ratios that use that measure, in schedules of required supplementary information. This Statement amends GASB Statements No. 67 and No. 68 to instead require the presentation of covered payroll, defined as the payroll on which contributions to a pension plan are based, and ratios that use that measure. This Statement clarifies that a deviation, as the term is used in Actuarial Standards of Practice issued by the Actuarial Standards Board, from the guidance in an Actuarial Standard of Practice is not considered to be in conformity with the requirements of GASB Statement No. 67, GASB Statement No. 68, or GASB Statement No. 73 for the selection of assumptions used in determining the total pension liability and related measures. This Statement clarifies that payments that are made by an employer to satisfy contribution requirements that are identified by the pension plan terms as plan member contribution requirements should be classified as plan member contributions for purposes of GASB Statement No. 67 and as employee contributions for purposes of GASB Statement No. 68. It also requires that an employer's expense and expenditures for those amounts be recognized in the period for which the contribution is assessed and classified in the same manner as the employer classifies similar compensation other than pensions (for example, as salaries and wages or as fringe benefits). This Statement is not effective until fiscal year 2017, except for the requirements of this Statement for the selection of assumptions in a circumstance in which an employer's pension liability is measured as of a date other than the employer's most recent fiscal year-end. In that circumstance, the requirements for the selection of assumptions are effective for that employer in the first reporting period in which the measurement date of the pension liability is on or after June 15, 2017. The System is evaluating the impact of this new statement.

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- GASB Statement No. 85, *Omnibus 2017*. The objective of this Statement is to address practice issues that have been identified during implementation and application of certain GASB Statements. This Statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application, and postemployment benefits (including both pensions and OPEB). The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2017. The System is evaluating the impact of this new statement.
- GASB Statement No. 87, *Leases*. The objective of this Statement is to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments. This Statement increases the usefulness of governments' financial statements by requiring recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities. The provisions of this Statement are effective for financial statements for periods beginning after December 15, 2019. The System is evaluating the impact of this new statement.
- GASB Statement No. 88, *Certain disclosures related to debt, including direct borrowings and direct placements*. The primary objective of this Statement is to improve the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. It also clarifies which liabilities governments should include when disclosing information related to debt. This Statement defines debt for purposes of disclosure in notes to financial statements as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established. This Statement requires that additional essential information related to debt be disclosed in notes to financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective acceleration clauses. For notes to financial statements related to debt, this Statement also requires that existing and additional information be provided for direct borrowings and direct placements of debt separately from other debt. The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2018. The System is evaluating the impact of this new statement.

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**(3) Going Concern**

As of June 30, 2016, the System was severely underfunded. As of June 30, 2016 the System's net pension liability was approximately \$37,699 million and its fiduciary net position was approximately negative \$1,266 million. The Commonwealth and the other participating employers have been facing significant fiscal and economic challenges in recent years due to, among other factors, continued budget deficits, a prolonged economic recession, high unemployment, population decline, and high levels of debt and pension obligations that have significantly inhibited their ability to make employer contributions to the System. Accordingly, the annual benefit payments and administrative expenses paid by the System have been significantly larger than the member and employers' contributions, resulting in the System going into a deficit position in fiscal year 2016.

On May 2, 2017, the legal shield granted by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) protecting the Commonwealth from debt-related lawsuits expired. On May 3, 2017, the Commonwealth filed a petition for protection under Title III of PROMESA to ensure the essential services to the public, the payment of the government payroll and the suppliers.

Faced with the eventual insolvency of the System and the inability to reach a consensual restructuring agreement with the System's creditors, on May 21, 2017, the Governor submitted a letter to the Financial Oversight and Management Board for Puerto Rico created by PROMESA (the Oversight Board) stating that the System desired to effect a plan to adjust its debts under Title III of PROMESA. Also, on May 21, 2017, the Oversight Board filed a petition for the System in the United States District Court for the District of Puerto Rico, commencing a Title III case for the System. On June 15, 2017, the United States Trustee appointed an Official Committee of Retired Employees in the Commonwealth's Title III cases. As further described in note 14.E., in the System sold investments in July 2017 in the total amount of approximately \$297 million.

*Management's Conclusion on Going Concern Consideration*

Based on the fiscal and financial difficulties of both the Commonwealth and the System discussed above, management believes there is substantial doubt about the ability of the System to continue as a going concern.

*Management's Remediation Plan*

On June 27, 2017, the Treasury Department issued Circular Letter No. 1300-46-17 in order to convey to the central government agencies, public corporations and municipalities the new implementation procedures to adopt, effective July 1, 2017, a new PayGo mechanism for the payment of pensions. Subsequently, on August 23, 2017, the Governor signed into law Act No. 106, which established by law the PayGo system for the payment of accumulated pension benefits and reformed the Commonwealth's Retirement Systems so that their active participants would deposit their individual contributions in a new Defined Contribution Plan among other significant changes. For additional information on the PayGo mechanism and Act No. 106, refer to note 14.

Act No. 106 also suspended the System's loan program and seeks to reduced general and administrative expenses mostly through employee attrition due to normal retirement and reduction in professional services contracts.

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**(4) Plan Description**

*Pension Benefits*

The System administers different benefit structures pursuant to Act No. 447, as amended, including a cost-sharing, multi-employer, defined benefit program, a defined contribution program (System 2000 program) and a contributory hybrid program. Benefit provisions vary depending on member's date of hire. Substantially all full-time employees of the Commonwealth and its instrumentalities (73 Commonwealth agencies, 78 municipalities, and 55 public corporations, including the System) are covered by the System. Membership is mandatory for all regular, appointed, and temporary employees of the Commonwealth at the date of employment. Membership is optional for the Governor, Commonwealth secretaries, and the heads of public agencies and instrumentalities, among others.

At July 1, 2015, membership of the System consisted of the following:

Retirees and beneficiaries currently receiving benefits	109,649
Current participating employees – defined benefit	54,074
Current participating employees – System 2000 and Act No. 3	65,605
Disabled members, receiving benefits	<u>15,444</u>
Total membership	<u><u>244,772</u></u>

The benefits provided to members of the System are established by Commonwealth law and may be amended only by the Legislative Assembly of Puerto Rico (the Legislative Assembly) with the Governor's approval. Act No. 3, in conjunction with other recent funding and design changes, provided for a comprehensive reform of the System. This summary details the provisions under Act No. 3.

Certain provisions are different for the three groups of members who entered the System prior to July 1, 2013 as described below:

- Members of Act No. 447 are generally those members hired before April 1, 1990 (contributory, defined benefit program).
- Members of Act No. 1 are generally those members hired on or after April 1, 1990 and on or before December 31, 1999 (contributory, defined benefit program).
- Members of Act No. 305 (or System 2000) are generally those members hired on or after January 1, 2000 and on or before June 30, 2013 (defined contribution program).

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All regular employees hired for the first time on or after July 1, 2013, and former employees who participated in the defined benefit program and the System 2000 program, and were rehired on or after July 1, 2013, become members of the Contributory Hybrid Program as a condition to their employment. In addition, employees who at June 30, 2013 were participants of previous programs became part of the Contributory Hybrid Program on July 1, 2013.

Each member has a nonforfeitable right to the value of his or her account. Members have three options to invest their contributions. Investment income is credited to the member's account semi-annually. The Commonwealth does not guarantee benefits at retirement age.

The assets of the defined benefit program, the defined contribution program and the Contributory Hybrid Program are pooled and invested by the System. Future benefit payments will be paid from the same pool of assets.

This summary of the System's plan provisions is intended to describe the essential features of the plan. All eligibility requirements and benefit amounts shall be determined in strict accordance with the applicable plan documents.

**(a) Service Retirements**

- (1) *Eligibility for Act No. 447 Members* – Act No. 447 members who were eligible to retire as of June 30, 2013 continue to be eligible to retire at any time. Prior to July 1, 2013, Act No. 447 members could retire upon (1) attainment of age 55 with 25 years of credited service, (2) attainment of age 58 with 10 years of credited service, (3) any age with 30 years of credited service, (4) for Public Officers in High Risk Positions (the Commonwealth Police and Firefighter Corps, the Municipal Police and Firefighter Corps and the Custody Office Corps), attainment of age 50 with 25 years of credited service, and (5), for Mayors of municipalities, attainment of age 50 with 8 years of credited service as a Mayor. In addition, Act No. 447 members who attained 30 years of credited service by December 31, 2013 are eligible to retire at any time.

Act No. 447 members who were not eligible to retire as of June 30, 2013 and did not attain 30 years of credited service by December 31, 2013 are eligible to retire upon attainment of the retirement eligibility age shown in the table below with 10 years of credited service.

<u>Date of birth</u>	<u>Attained age as of June 30, 2013</u>	<u>Retirement eligibility age</u>
July 1, 1957 or later	55 or less	61
July 1, 1956 to June 30, 1957	56	60
Before July 1, 1956	57 and up	59

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In addition to the requirements in the table above, Act No. 447 provides that Public Officers in High Risk Positions who were not eligible to retire as of June 30, 2013 and did not attain 30 years of credited service by December 31, 2013 are eligible to retire directly from active service upon the attainment of age 55 with 30 years of credited service.

- (2) *Eligibility for Act No. 1 Members* – Act No. 1 members who were eligible to retire as of June 30, 2013 continue to be eligible to retire at any time. Prior to July 1, 2013, Act No. 1 members could retire upon (1) attainment of age 55 with 25 years of credited service, (2) attainment of age 65 with 10 years of credited service, (3) for Public Officers in High Risk Positions, any age with 30 years of credited service, and (4) for Mayors, attainment of age 50 with 8 years of credited service as a Mayor.

Act No. 1 members who were not eligible to retire as of June 30, 2013 are eligible to retire upon attainment of age 65 with 10 years of credited service. In addition, Act No. 1 Public Officers in High Risk Positions who were not eligible to retire as of June 30, 2013 are eligible to retire directly from active service upon the attainment of age 55 with 30 years of credited service.

- (3) *Eligibility for System 2000 Members* – System 2000 members who were eligible to retire as of June 30, 2013 continue to be eligible to retire at any time. Prior to July 1, 2013, System 2000 members could retire upon attainment of age 55 for Public Officers in High Risk Positions and attainment of age 60 otherwise.

System 2000 members who were not eligible to retire as of June 30, 2013 are eligible to retire upon attainment of age 55 for Public Officers in High Risk Positions and upon attainment of the retirement eligibility age shown in the table below otherwise.

<u>Date of birth</u>	<u>Attained age as of June 30, 2013</u>	<u>Retirement eligibility age</u>
July 1, 1957 or later	55 or less	65
July 1, 1956 to June 30, 1957	56	64
July 1, 1955 to June 30, 1956	57	63
July 1, 1954 to June 30, 1955	58	62
Before July 1, 1954	59 and up	61

- (4) *Eligibility for Members Hired after June 30, 2013* – Attainment of age 58 if a Public Officer in a High Risk Position and attainment of age 67 otherwise.



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**(b) Service Retirement Annuity Benefits**

An annuity is payable for the lifetime of the member equal to the annuitized value of the balance in the hybrid contribution account at the time of retirement, plus, for Act No. 447 and Act No. 1 members, the accrued benefit determined as of June 30, 2013. If the balance in the hybrid contribution account is \$10,000 or less, it shall be paid as a lump sum instead of as an annuity.

- (1) *Accrued Benefit as of June 30, 2013 for Act No. 447 Members* – The accrued benefit as of June 30, 2013 shall be determined based on the average compensation, as defined, for Act No. 447 members, the years of credited service, and the attained age of the member all as of June 30, 2013. For Act No. 447 Mayors, the highest compensation, as defined, as a Mayor is determined as of June 30, 2013.

If the Act No. 447 member had at least 30 years of credited service as of June 30, 2013, the accrued benefit equals 65% of average compensation if the member was under age 55 as of June 30, 2013 or 75% of average compensation if the member was at least age 55 as of June 30, 2013. For participants selecting to coordinate with social security (the Coordination Plan), the benefit is re-calculated at the Social Security Retirement Age (SSRA), as defined, as 1.5% of average compensation up to \$6,600 multiplied by years of credited service, up to 30 years, plus 65% (75% if member was at least age 55 as of June 30, 2013) of average compensation in excess of \$6,600.

If the Act No. 447 member had less than 30 years of credited service as of June 30, 2013, and attains 30 years of credited service by December 31, 2013, the accrued benefit equals 55% of average compensation if the member was under age 55 as of June 30, 2013 or 60% of average compensation if the member was at least age 55 as of June 30, 2013. For participants selecting the Coordination Plan, the benefit is re-calculated at SSRA as 1.5% of average compensation up to \$6,600 multiplied by years of credited service, up to 30 years, plus 55% (60% if member was at least age 55 as of June 30, 2013) of average compensation in excess of \$6,600. Member contributions received from Act No. 447 members eligible for this transitory benefit during the period beginning July 1, 2013 and ending upon the attainment of 30 years of credited service are considered pre-July 1, 2013 contributions; the contributions to the hybrid contribution account begin after the member attains 30 years of credited service.

If the Act No. 447 member had less than 30 years of credited service as of December 31, 2013, the accrued benefit equals 1.5% of average compensation multiplied by years of credited service up to 20 years, plus 2% of average compensation multiplied by years of credited service in excess of 20 years. Maximum benefit is 75% of average compensation. Except for Commonwealth Police and Commonwealth Firefighters, the benefit is actuarially reduced for each year payment commences prior to age 58. For participants selecting the Coordination Plan, the basic benefit is re-calculated at SSRA as 1% of average compensation up to \$6,600 multiplied by years of credited service up to 20 years, plus 1.5% of average compensation up to \$6,600 multiplied by years of credited service in excess of 20 years, plus 1.5% of average compensation in excess of \$6,600 multiplied by years of credited service up to 20 years, plus 2.0% of average compensation in excess of \$6,600 multiplied by years of credited service in excess of 20 years. Except for Police



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and Firefighters, the benefit is actuarially reduced for each year payment commences prior to age 58.

For Act No. 447 Mayors with at least 8 years of credited service as a mayor, the accrued benefit will not be less than 5% of highest compensation, as defined, as a Mayor for each year of credited service as a Mayor up to 10 years, plus 1.5% of highest compensation as Mayor for each year of non-Mayoral credited service up to 20 years, plus 2.0% of highest compensation as Mayor for each year of non-Mayoral credited service in excess of 20 years. Non-Mayoral credited service includes service earned as a Mayor in excess of 10 years. Maximum benefit is 90% of highest compensation as a Mayor.

- (2) *Accrued Benefit as of June 30, 2013 for Act No. 1 Members* – The accrued benefit as of June 30, 2013 shall be determined based on the average compensation for Act No. 1 members, the years of credited service, and the attained age of the member all as of June 30, 2013. For Act No. 1 Mayors, the highest compensation as a Mayor is determined as of June 30, 2013.

If the Act No. 1 member is a police officer or firefighter with at least 30 years of credited service as of June 30, 2013, the accrued benefit equals 65% of average compensation if the member was under age 55 as of June 30, 2013 or 75% of average compensation if the member was at least age 55 as of June 30, 2013.

For all other Act No. 1 members, the accrued benefit equals 1.5% of average compensation multiplied by years of credited service. The benefit is actuarially reduced for each year payment commences prior to age 65.

For Act No. 1 Mayors with at least 8 years of credited service as a mayor, the accrued benefit will not be less than 5% of highest compensation as a Mayor for each year of credited service as a Mayor up to 10 years, plus 1.5% of highest compensation as Mayor for each year of non-Mayoral credited service up to 20 years, plus 2.0% of highest compensation as Mayor for each year of non-Mayoral credited service in excess of 20 years. Non-Mayoral credited service includes service earned as a Mayor in excess of 10 years. Maximum benefit is 90% of highest compensation as a Mayor.

**(c) Compulsory Retirement**

All Act No. 447 and Act No. 1 Public Officers in High Risk Positions must retire upon attainment of age 58 and 30 years of credited service. A two year extension may be requested by the member from the Superintendent of the Puerto Rico Police, the Chief of the Firefighter Corps, or supervising authority as applicable.

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**(d) Termination Benefits**

**(1) Lump Sum Withdrawal**

**Eligibility:** A Member is eligible upon termination of service prior to 5 years of service or if the balance in the hybrid contribution account is \$10,000 or less.

**Benefit:** The benefit equals a lump sum payment of the balance in the hybrid contribution account as of the date of the permanent separation of service.

**(2) Deferred Retirement**

**Eligibility:** A Member is eligible upon termination of service with 5 or more years of service (10 years of credited service for Act No. 447 and Act No. 1 members) prior to the applicable retirement eligibility, provided the member has not taken a lump sum withdrawal of the accumulated contributions and the hybrid contribution account.

**Benefit:** An annuity payable for the lifetime of the member commencing at the applicable retirement eligibility age is equal to the annuitized value of the balance in the hybrid contribution account at the time of retirement, plus, for Act No. 447 and Act No. 1 members, the accrued benefit determined as of June 30, 2013.

**(e) Death Benefits**

**(1) Pre-Retirement Death Benefit**

**Eligibility:** Any current nonretired member is eligible.

**Benefit:** A refund of the hybrid contribution account, plus the accumulated contributions for Act No. 447 and Act No. 1 members.

**(2) High-Risk Death Benefit under Act No. 127**

**Eligibility:** Police, firefighters, and other employees in specified high-risk positions who die in the line of work due to reasons specified in Act No. 127 of 1958, as amended.

**Spouse's Benefit:** 50% of the participant's compensation at date of death, payable as an annuity until death or remarriage.

**Children's Benefit:** 50% of the participant's compensation at date of death, payable as an annuity, and allocated pro-rata among eligible children. The annuity is payable for life for a disabled child, until age 18 for a nondisabled child not pursuing studies, and until age 25 for a nondisabled child who is pursuing studies.

**Benefit if No Spouse or Children:** The parents of the member shall each receive 50% of the participant's compensation at date of death, payable as an annuity for life.

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**Post-death Increases:** Effective July 1, 1996 and subsequently every three years, the above death benefits are increased by 3% provided that the beneficiary(ies) had been receiving payments for at least three years.

The cost of these benefits is paid by the Commonwealth's General Fund.

**(3) Post-Retirement Death Benefit for Members who Retired prior to July 1, 2013**

**Eligibility:** Any retiree or disabled member receiving a monthly benefit who has not elected a reversionary annuity and whose benefits commenced prior to July 1, 2013.

**Benefit:** The benefit is as follows (Law No. 105, as amended by Law No. 4):

- (i) For those married or with dependent children at the time of death, the annual income to a widow, or widower or dependent children is equal to 60% (50% if in the Coordination Plan – 30% prior to January 1, 2004) of the retirement benefit payable for life for a surviving spouse and/or disabled children and payable until age 18 (age 25 if pursuing studies) for nondisabled children. If in the Coordination Plan, the benefit to the surviving spouse does not begin until the spouse's attainment of age 60 and the surviving spouse must have been married to the member for at least 10 years to be eligible for this benefit. The increase in the percentage from 30% to 50% if the Coordination Plan is paid by the Commonwealth's General Fund for former government employees or by the public enterprise or municipality for their former employees.
- (ii) The benefit, when there is no relation as stated above, is equal to the remaining balance of accumulated contributions at the time of retirement after the deduction of lifetime annual income paid and is payable to a beneficiary or to the member's estate. In no case shall the benefit be less than \$1,000. Either the Commonwealth's General Fund for former government employees or the public enterprise or municipality for their former employees pays the difference, up to \$250, between (1) the accumulated contributions less the lifetime annual income paid and (2) \$1,000. The System pays for the rest.

**(4) Post-Retirement Death Benefit for Members who Retired after June 30, 2013**

**Eligibility:** Any retiree or disabled member who began receiving a monthly benefit after June 30, 2013.

**Benefit:** If the member elected at the time of retirement to transfer a portion of the annuity to a beneficiary by selecting an actuarially equivalent optional form of payment, the benefit is the applicable survivor benefit selected.

For all members, the excess, if any, of the hybrid contribution account, plus the accumulated contributions for Act No. 447 and Act No. 1 members, at the time of retirement over the total annuity payments paid to the member and any beneficiary per the terms of the optional form of payment shall be payable to a beneficiary or the member's estate.

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- (5) Beneficiaries receiving occupational death benefits as of June 30, 2013 continue to be eligible to receive such benefits.

**(f) Disability Benefits**

**(1) Disability**

**Eligibility:** All members are eligible upon the occurrence of disability.

**Benefit:** The balance of the hybrid contribution account payable as lump sum distribution, an immediate annuity or a deferred annuity at the election of the participant. Act No. 447 and Act No. 1 members remain eligible to receive the accrued benefit as of June 30, 2013 commencing at the applicable retirement eligibility age.

**(2) High Risk Disability under Act No. 127**

**Eligibility:** Police, firefighters, and other employees in specified high-risk positions who are disabled in the line of work due to reasons specified in Act No. 127 of 1958 (as amended).

**Benefit:** 80% (100% for Act No. 447 members) of compensation as of date of disability, payable as an annuity. If the member dies while still disabled, this annuity benefit continues to his beneficiaries. Beneficiaries include the surviving spouse and/or disabled children (for life), nondisabled children until age 18 (age 25 if pursuing studies), and the parents if no other beneficiaries. Effective July 1, 1996 and subsequently every three years, the disability benefit is increased by 3% provided that the member (or beneficiary) had been receiving payments for at least three years (Act No. 127 of 1958, as amended). The cost of these benefits is paid by the Commonwealth's General Fund.

- (3) Members who qualified for occupational or nonoccupational disability benefits as of June 30, 2013 continue to be eligible to receive such benefits.

**(g) Special Benefits**

**(1) Minimum Benefits**

**(i) Past Ad hoc Increases**

The Legislative Assembly, from time to time, increases pensions for certain retirees as described in Act No. 124 approved on June 8, 1973 and Act No. 23 approved on September 23, 1983. The benefits are paid 50% by the Commonwealth's General Fund and 50% by the System.

- (ii) Minimum Benefit for Members who Retired before July 1, 2013 (Act No. 156 of 2003, Act No. 35 of 2007, and Act No. 3)**

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The minimum monthly lifetime income for members who retired or become disabled before July 1, 2013 is \$500 per month effective July 1, 2013 (\$400 per month effective July 1, 2007 and \$300 per month up to June 30, 2007). The increase in the minimum monthly benefit from \$200 per month to \$300 per month is paid by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees. The increase in the minimum monthly benefit from \$300 per month to \$400 per month is to be paid by the System for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

(iii) Coordination Plan Minimum Benefit

A minimum monthly benefit is payable upon attainment of SSRA such that the benefit, when added to the Social Security Benefit, is not less than the benefit payable prior to SSRA.

(2) *Cost-of-Living Adjustments (COLA) to Pension Benefits*

The Legislative Assembly, from time to time, increases pensions by 3% for retired and disabled members. Beneficiaries are not entitled to COLAs granted after the retiree's death. The first increase was granted by Act No. 10 of 1992. Subsequent 3% increases have been granted every third year since 1992, with the latest 3% increase established on April 24, 2007 and effective July 1, 2007 (retroactive to January 1, 2007) for retired and disabled members that were receiving a monthly benefit on or before January 1, 2004. In addition, effective July 1, 2008, any retired or disabled member that was receiving a monthly annuity on or before January 1, 2004 less than \$1,250 per month received an increase of up to 3% without exceeding the limit of \$1,250 per month. The COLAs granted in 1992 to all retirees and in 1998 to retirees who are former government or municipal employees shall be paid by the System. All other COLAs granted in 1995 and later shall be paid by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

(3) Special "Bonus" Benefits

(i) Christmas Bonus (Act No. 144, as Amended by Act No. 3)

An annual bonus of \$200 for each retiree, beneficiary, and disabled member paid in December provided the member retired prior to July 1, 2013. This benefit is paid from the supplemental contributions received from the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

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(ii) Medication Bonus (Act No. 155, as Amended by Act No. 3)

An annual bonus of \$100 for each retiree, beneficiary, and disabled member to cover health costs paid in July provided the member retired prior to July 1, 2013. Evidence of coverage is not required. The amount is prorated if there are multiple beneficiaries. This benefit is paid from the supplemental contributions received from the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

**(h) Contributions**

*(1) Member Contributions*

Effective July 1, 2013, contributions by members are 10% of compensation. However, for Act No. 447 members who selected the Coordination Plan, the member contributions are 8.5% of compensation up to \$6,600 plus 10% of compensation in excess of \$6,600 during the 2014-2015 fiscal year and 10% of compensation up to during the 2015-2016 fiscal year and after Members may voluntarily make additional contributions to their hybrid contribution account.

Prior to July 1, 2013, contributions by Act No. 447 members selecting the Coordination Plan were 5.775% of compensation up to \$6,600 plus 8.275% of compensation in excess of \$6,600. Contributions by all other members were 8.275% of compensation. System 2000 members may also have made voluntary contributions of up to 1.725% of compensation prior to July 1, 2013.

*(2) Employer Contributions (Article 2-116, as Amended by Law No. 116 of 2010 and Act No. 3)*

Prior to July 1, 2011, employer contributions were 9.275% of compensation. Effective July 1, 2011, employer contributions are 10.275% of compensation. For the next four fiscal years effective July 1, employer contributions will increase annually by 1% of compensation. For the five fiscal years thereafter, employer contributions will increase annually by 1.25% of compensation, reaching an employer contribution rate of 20.525% of compensation effective July 1, 2020.

*(3) Supplemental Contributions from the Commonwealth's General Fund, Certain Public Corporations, and Municipalities (Act No. 3)*

Effective July 1, 2013, the System will receive a supplemental contribution of \$2,000 each fiscal year for each pensioner (including beneficiaries receiving survivor benefits) who was previously benefitting as an Act No. 447 or Act No. 1 member while an active employee. This supplemental contribution will be paid by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees or by certain public corporations with their own treasuries or municipalities for their former employees.

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*(4) Additional Uniform Contribution (Act No. 32, as Amended)*

The additional uniform contribution will be certified by the external actuary of the System each fiscal year from 2015-2016 as necessary to avoid having the projected gross assets of the System, during any subsequent fiscal year, to fall below \$1 billion. The additional uniform contribution is to be paid by the Commonwealth's General Fund, public corporations with their own treasuries, and municipalities. Total additional uniform contribution determined for fiscal years 2015, 2016 and 2017 was \$776 million. As further described in notes 3 and 14(c), the additional uniform contribution was eliminated in June 2017.

*(i) Early Retirement Programs*

The Puerto Rico Environmental Quality Board (EQB) implemented an early retirement program for its employees under the Law 224 Act No. 7, dated August 9, 2008. EQB has already made the initial payment and would reimburse the remaining balance on annuities and other benefits paid by the System in four installments on each July 31 starting in 2009 through 2012. The EQB was at default on the retirement plan payment, so they requested a new payment plan. The System's Board of Trustees approved a payment plan for the debt balance due of the retirement program for 24 months starting in March 2014.

On July 2, 2010, the Commonwealth enacted Act No. 70 establishing a program that provides benefits for early retirement or economic incentives for voluntary employment termination to eligible employees, as defined. Act No. 70 of 2010 (Act No. 70) also established that early retirement benefits will be provided to eligible employees that have completed between 15 to 29 years of creditable services and will consist of monthly benefits ranging from 37.5% to 50% of each employees' monthly salary. Benefits under this program will be paid by the Commonwealth's General Fund and by the public corporations, covering their respective employees until the plan member reaches the later of age 55 for members under Act No. 447 or age 65 for members under Act No. 1, or the date the plan member would have completed 30 years of service had the member continued employment. In addition, the public corporations will also be required to continue making the required employee and employer contributions to the System. The Commonwealth's General Fund will be required to continue making its required employer contributions. The System will be responsible for benefit payments afterwards. As of June 30, 2016, the System recorded a liability of approximately \$16 million for its responsibility as an employer under Act No. 70.

The contribution requirement to the System is established by law and is not actuarially determined. The special benefits contributions of approximately \$196.7 million in 2016 mainly represent contributions from the Commonwealth's General Fund, public corporations and municipalities for the special benefits identified above granted by special laws. The funding of the special benefits is provided to the System through legislative appropriations each July 1 by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees, and by certain public corporations with their own treasuries and municipalities for their former employees. The legislative appropriations are considered estimates of the payments to be made by the System for the special benefits. Deficiencies in legislative appropriations are covered by the System's own funds until recovered through future legislative appropriations. Any surplus of legislative appropriations collected



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over special benefits paid is combined with the assets held in trust for the payment of other pension benefits.

**(j) Other Postemployment Benefits (OPEB) – Healthcare Benefits**

ERS MIPC is an unfunded, cost-sharing, multi-employer defined benefit other postemployment benefit plan sponsored by the Commonwealth. ERS MIPC covers a payment of up to \$100 per month to the eligible medical insurance plan selected by the member provided the member retired prior to July 1, 2013 (Act No. 483, as amended by Act No. 3). Substantially all fulltime employees of the Commonwealth's primary government, and certain municipalities of Puerto Rico and certain component units of the Commonwealth not having their own postemployment benefit plan, were covered by the OPEB.

Commonwealth employees became members upon their date of employment. Plan members were eligible for benefits upon reaching the pension benefits retirement ages.

At July 1, 2015, the membership consisted of the following:

Membership:	
Retired members	94,979
Disabled members	<u>15,444</u>
Total membership	<u><u>110,423</u></u>

The contribution requirement of ERS MIPC is established by Act No. 95 approved on June 29, 1963. This OPEB plan is financed by the Commonwealth on a pay-as-you-go basis. There is no contribution requirement from the plan member during active employment. Retirees contribute the amount of the healthcare insurance premium not covered by the Commonwealth contribution. As a result, these OPEB are 100% unfunded. During the year ended June 30, 2016, OPEB contributions amounted to \$94 million.

The funding of the OPEB benefits is provided to the System through legislative appropriations each July 1 by the Commonwealth's General Fund for former government and certain public corporations without their own treasuries employees, and by certain public corporations with their own treasuries and municipalities for their former employees. The legislative appropriations are considered estimates of the payments to be made by the System for the healthcare benefits throughout the year.



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**(5) Net Pension Liability**

The components of the net pension liability as of June 30, 2016 were as follows (dollars in thousands):

Total pension liability	\$	36,432,873
Plan's fiduciary net deficit		<u>(1,265,885)</u>
Net pension liability	\$	<u>37,698,758</u>
Plan's fiduciary net deficit as a percentage of the total pension liability		(3.47)%

**(a) Actuarial Methods and Assumptions**

The census data collection date is at beginning-of-year. The liability results as of June 30, 2016 are based on projecting the System obligations determined as of the census data collection date of July 1, 2015 for one year, using roll-forward methods and assuming no liability gains or losses.

The actuarial valuation used the following actuarial assumptions:

Inflation	2.50%
Municipal bond index	2.85%, as per Bond Buyer General Obligation 20-Bond Municipal Bond Index
Projected salary increases	3.00% per year. No compensation increases are assumed until July 1, 2021 as a result of Act No. 3-2017 and the current general economy.
Mortality	Pre-retirement Mortality: For general employees not covered under Act No. 127, RP-2014 Employee Mortality Rates for males and females adjusted to reflect Mortality Improvement Scale MP-2016 from the 2006 base year, and projected forward using MP-2016 on generational basis. For members covered under Act No. 127, RP-2014 Employee Mortality Rates with blue collar adjustments for males and females adjusted to reflect Mortality Improvement Scale MP-2016 from the 2006 base year, and projected forward using MP-2016 on generational basis. As generational tables, they reflect mortality improvements both before and after the measurement date.

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100% of deaths while in active service are assumed to be occupational for members covered under Act No. 127.

**Post-retirement Healthy Mortality:**

Rates which vary by gender are assumed for healthy retirees and beneficiaries based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 92% of the rates from the UP-1994 Mortality Table for Males and 95% of the rates from the UP-1994 Mortality Table for Females, both projected from 1994 to 2010 using Scale AA. The base rates are projected using Mortality Improvement Scale MP-2016 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

**Post-retirement Disabled Mortality:**

Rates which vary by gender are assumed for disabled retirees based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 105% of the rates from the UP-1994 Mortality Table for Males and 115% of the rates from the UP-1994 Mortality Table for Females. The base rates are projected using Mortality Improvement Scale MP-2016 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

Most other demographic assumptions used in the June 30, 2016 valuation were based on the results of an actuarial experience 2009 study using data as of June 30, 2003, June 30, 2005 and June 30, 2007.

**(b) Long-Term Expected Rate of Return**

The long-term expected rate of return on pension benefits investments was determined in accordance with the asset allocation of the portfolio that was adopted by the System's Board of Trustees during December 2013 and the actuary's capital market assumptions as of June 30, 2016. In addition, the assumption reflects that loans to members comprise approximately 20% of the portfolio and, have an approximate return of 9.1% with no volatility. The long-term expected rate of return on pension benefits investments of 6.55% as of June 30, 2016 equal to the highest debt service of the senior pension funding bonds payable which range from 5.85% per year to 6.55% per year.

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The pension plan's policy in regard to allocation of invested assets is established and may be amended by the System's Board of Trustees. Plan assets are managed on a total return basis with a long-term objective of achieving and maintaining a positive impact on the System's financial condition for the benefits provided through the pension programs. The following asset allocation policy as of June 30, 2016 was adopted by the System's Board of Trustees:

	<u>Target allocation</u>	<u>Long-term expected rate of return</u>
Asset class:		
Domestic equity	25 %	6.4 %
International equity	10	6.7
Fixed income	64	6.3
Cash	1	3.0
	<hr/>	
Total	100 %	
	<hr/>	

The long-term expected rate of return on pension benefits investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation.

**(c) Discount Rate**

The asset basis for the date of depletion projection is the System's fiduciary net position (the gross assets plus deferred outflows of resources less the gross liabilities, including the senior pension funding bonds payable, plus deferred inflows of resources). On this basis, the System's fiduciary net position was exhausted in the fiscal year 2015.

The System's fiduciary net position was not projected to be available to make all projected future benefit payments of current active and inactive employees. Therefore, the tax free municipal bond index (Bond Buyer General Obligation 20-Bond Municipal Bond Index) was applied to all periods of projected benefits payments to determine the total pension liability. The discount rate was 2.85% as of June 30, 2016.

The date of depletion projection of the actuarial report does not include any amounts from the additional uniform contribution required by Act No. 32 because of actual fiscal and budgetary financial difficulties, continued budget deficits and liquidity risks of the Commonwealth and the municipalities, and in the event that their financial condition do not improve in the near term.

The June 30, 2016, actuarial valuation reflects an increase of \$4,361 million in the net pension liability as a result of the changes in assumptions of \$3,854 million, mainly related to the decrease in the

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discount rate as required by GASB Statement No. 67 from 3.80% in fiscal year 2015 to 2.85% in fiscal year 2016 and the Plan Fiduciary Net Deficit Position of approximately \$1,266 million as of June 30, 2016, which effects were offset by a decrease of \$252 million in the total pension liability as a result differences between expected and actual experience.

**(d) Sensitivity of the Net Pension Liability to Changes in the Discount Rate**

The following presents the net pension liability calculated using the discount rate of 2.85%, as well as what it would be if it were calculated using a discount rate of 1%-point lower (1.85%) or 1% point higher (3.85%) than the current rate (dollars in thousands):

	<u>1% Decrease (1.85%)</u>	<u>Current discount rate (2.85%)</u>	<u>1% Increase (3.85%)</u>
Net pension liability	\$ 43,200,603	37,698,758	33,149,507

**(6) Cash and Cash Equivalents, Investments and Securities Lending Transactions**

*Cash and Cash Equivalents*

Cash and cash equivalents as of June 30, 2016 consisted of the following (in thousands):

	<u>Carrying amount</u>	<u>Depository bank balance</u>	<u>Amount uninsured and uncollateralized</u>
Deposits with GDB	\$ 210,765	228,034	228,034
Deposits with Puerto Rico commercial banks	255,387	249,605	—
Money market funds	185,889	—	—
U.S. Treasury bill	170	—	—
Total	<u>\$ 652,211</u>	<u>477,639</u>	<u>228,034</u>

Custodial credit risk for deposits is the risk that, in an event of the failure of a depository financial institution, the System may not be able to recover deposits or collateral securities that are in the possession of an outside party. The Commonwealth requires that public funds deposited in Puerto Rico commercial banks be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. Deposits with GDB and with non-Puerto Rico commercial banks and money market funds are uninsured and uncollateralized, as these entities are exempt from compliance with the collateralization requirement.

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Restricted cash and cash equivalent amounted to approximately \$187.7 million as of June 30, 2016 and consisted of the following:

- Approximately \$85.4 million of funds are restricted for the debt service of the bonds payable, and 100% of such funds were deposited at trustee in money market funds.
- Approximately \$102.2 million of funds are restricted for repayments of mortgage and personal loans administrated by the mortgage servicers and the System, for expired checks not claim by the plan members, and other purposes, of which approximately \$83.3 million of funds were deposited at trustee in money market accounts, approximately \$6.3 million of funds were deposited at GDB and approximately \$12.6 million were deposited at Puerto Rico commercial banks.

*Custodial Credit Loss on Deposits with GDB*

Management concluded that the information available prior to the issuance of the System's financial statements for the year ended June 30, 2016 indicates that it is probable that an impairment loss on the System's deposits held with GDB exists as of June 30, 2016.

The Commonwealth and its public entities have not been able to repay their loans from GDB, which has significantly affected GDB's liquidity and ability to repay its obligations.

GDB faces significant risks and uncertainties and it currently does not have sufficient liquid financial resources to meet obligations when they come due. Pursuant to enacted legislation in April 2016, as explained in note 14, the Governor of the Commonwealth ordered the suspension of loan disbursements by GDB, imposed restrictions on the withdrawal and transfer of deposits from GDB, and imposed a moratorium on debt obligations of GDB, among other measures.

Because of the nonpayment by the Commonwealth of the appropriation to GDB and GDB's inability to restructure its debt considering the broader fiscal crisis faced by the Commonwealth, GDB is in default of its debt obligations since May 1, 2016. In April 2016, the Governor imposed on GDB emergency operational restrictions and debt moratorium.

Due to the conditions and events described above, GDB's management believes substantial doubt exists as the GDB's ability to continue as a going concern.

On April 28, 2017, the Oversight Board approved the liquidation proposal included in the GDB's fiscal plan, that calls for an orderly winding down its operations over ten years.

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Based on an evaluation of the availability and recoverability of such funds, a custodial credit loss on these deposits has been recorded on the System's financial statements as follows (expressed in thousands):

	<b>Deposits held with GDB at June 30, 2016</b>		
	<b>Carrying value before impairment loss</b>	<b>Custodial credit loss</b>	<b>Carrying value</b>
Type of deposit:			
Interest bearing accounts	\$ 189,614	(20,935)	168,679
Time deposit	42,086	—	42,086
Total	<u>\$ 231,700</u>	<u>(20,935)</u>	<u>210,765</u>

In addition, management estimates that additional custodial credit losses on deposits held with GDB of approximately \$9 million will be recorded in the System's financial statements for the year ended June 30, 2017 corresponding to new certificates of deposit opened during such fiscal years for a total custodial credit loss on deposits held with the GDB of approximately \$30 million as of April 30, 2017. The realizable balance of the deposits held with the GDB as of June 30, 2016 was determined based on the corresponding actual collections received from the GDB on such deposits after the June 30, 2016 year end.

*Investments*

For the year ended June 30, 2016, the annual money-weighted rate of return on investments, net of investment expenses, was 6.55%. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested.

The System's investments are exposed to custodial credit risk, credit risk, concentration of credit risk, foreign currency risk, and interest rate risk. Following is a description of these risks as of June 30, 2016:

**(a) Custodial Credit Risk**

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2016, securities investments were registered in the name of the System and were held in the possession of the System's custodian banks, except for securities lent. Securities lent are not exposed to custodial credit risk. Cash collateral received from securities lending transactions invested in short-term investments is exposed to custodial credit risk.

**(b) Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. All fixed-income securities at the time of purchase must be of investment grade quality. All issuances shall be rated investment grade by at least two of the nationally recognized rating agencies. The portfolio is expected to maintain a minimum weighted average credit quality of either "A—" or better.

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The credit quality ratings of bonds and notes as of June 30, 2016, are as follows (in thousands):

Investment type	Rating (1)						CCC-	Not rated	Total
	AAA	AA+ to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-			
Bonds and notes:									
U.S. government sponsored agencies obligations:									
Federal Home Loan Bank (FHLB)	\$ —	2,908	—	—	—	—	—	—	2,908
Federal National Mortgage Association (FNMA)	—	4,117	—	—	—	—	—	—	4,117
Federal Home Loan Mortgage Corporation (FHLMC)	—	2,519	—	—	—	—	—	—	2,519
Federal Farm Credit Banks (FFCB)	—	3,678	—	—	—	—	—	—	3,678
Mortgage and asset-backed securities:									
FNMA	—	3,663	—	—	—	—	—	250	3,913
FHLMC	—	1,646	—	—	—	—	—	—	1,646
Commercial mortgages	—	—	—	—	—	—	—	1,533	1,533
U.S. corporate bonds and notes	8,489	37,691	88,587	86,039	5,793	—	224	7,226	232,049
Non U.S. corporate bonds	—	2,181	23,651	17,237	4,792	1,788	—	1,891	51,540
U.S. municipal bonds	1,108	1,424	—	1,157	—	—	—	—	3,689
COFINA bonds	—	—	—	—	—	—	93,484	—	93,484
Total bonds and notes	9,597	59,827	110,238	104,433	10,585	1,788	93,708	10,900	401,076
Total	\$ 9,597	59,827	110,238	104,433	10,585	1,788	93,708	10,900	401,076

(1) Rating obtained from Standard and Poor's or equivalent rating by Moody's Investor Service or Fitch Ratings.

Approximately \$44.8 million of the total System investments consist of U.S. government and Government National Mortgage Association (GNMA) mortgage-backed securities, which carry no risk, therefore, not included within the above table.

**(c) Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributed to the magnitude of the System's investment in a single issuer. As of June 30, 2016, there are no investments in any issuer that represent 5% or more of the System's total investments, except for its investment in certain bonds issued by the Puerto Rico Sales Tax Financing Corporation (known as COFINA by its Spanish acronym) (the COFINA Bonds).

Pursuant to Act No. 96 of June 16th, 2011, during the fiscal year ended June 30, 2011, the System received a special contribution of approximately \$163 million from the Puerto Rico Infrastructure Financing Authority, an instrumentality of the Commonwealth. The contribution was invested in COFINA Bonds, which provide for a 7% accretion rate and maturity dates between 2043 and 2048. COFINA is a blended component unit of the Commonwealth. As required by Act No. 96 of June 16th, 2011, the System cannot voluntarily dispose of the COFINA Bonds unless such request has been approved by the GDB. The COFINA Bonds had a fair value of approximately \$93.5 million as of June 30, 2016.

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**(d) Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. In accordance with its investment policy, the System manages its exposure to declines in fair values by structuring the investment portfolio so that securities mature to meet cash requirements for benefit payments, thereby avoiding the need to sell securities on the open market prior to maturity. Investments in equity securities are not subject to the maximum maturity policy since they do not carry a maturity date. The System is expected to achieve capital preservation and income generation by investing in a diversified portfolio of marketable, investment grade intermediate credit and core fixed-income securities.

The contractual maturity of investments as of June 30, 2016, is summarized below (in thousands). Expected maturities will differ from contractual maturities, because counterparties may have the right to call or prepay obligations with or without call or prepayment penalties.

Investment type	Maturity (in years)				Total
	Within one year	After one to five years	After five to ten years	After ten years	
Bonds and notes:					
U.S. government securities:					
U.S. Treasury notes	\$ 8,018	31,329	—	—	39,347
U.S. Treasury bonds	—	2,207	—	—	2,207
U.S. government sponsored agencies notes:					
FHLB	—	2,908	—	—	2,908
FNMA	—	4,117	—	—	4,117
FHLMC	—	2,519	—	—	2,519
FFCB	1,945	1,733	—	—	3,678
Mortgage and asset-backed securities:					
GNMA	1,213	2,048	—	—	3,261
FNMA	2,003	1,910	—	—	3,913
FHLMC	986	660	—	—	1,646
Commercial mortgages	—	1,533	—	—	1,533
U.S. corporate bonds and notes	23,304	196,242	10,415	2,088	232,049
Non U.S. corporate bonds	4,194	38,332	6,948	2,066	51,540
U.S. municipal bonds	611	3,078	—	—	3,689
COFINA bonds	—	—	—	93,484	93,484
<b>Total bonds and notes</b>	<b>\$ 42,274</b>	<b>288,616</b>	<b>17,363</b>	<b>97,638</b>	<b>445,891</b>



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Investment type	Maturity (in years)				Total
	Within one year	After one to five years	After five to ten years	After ten years	
Stocks, nonexchange commingled equity trust funds and investments in limited partnerships:					
U.S. corporate stock				\$	1,277
Nonexchange commingled equity trust funds:					
U.S. – SSgA Russell 3000 Fund					160,370
Non-U.S. – SSgA MSCI ACWI Ex USA Fund					59,215
Investments in limited partnerships					<u>47,461</u>
Total stocks, nonexchange commingled equity trust funds and investments in limited partnerships					<u>268,323</u>
Total investments				\$	<u><u>714,214</u></u>

(1) Nonexchange commingled fixed income trust fund was classified based on effective duration.

**(e) Foreign Currency Risk**

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit. As of June 30, 2016, the SSgA MSCI ACWI Ex USA Fund is subject to foreign currency risk.

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As of June 30, 2016, the composition of the underlying investments in the SSgA MSCI ACWI Ex USA Fund by country was as follows:

Country	SSgA MSCI ACWI EX USA Fund
Japan	17 %
United Kingdom	14
Canada	7
France	7
Switzerland	7
Germany	6
China	6
Australia	5
Korea	3
Taiwan	3
Spain	2
Hong Kong	2
India	2
Sweden	2
Others	17
Total	100 %

(i) *Nonexchange Commingled Trust Funds*

As of June 30, 2016, the System owned shares in the SSgA Russell 3000 Index Non-Lending Fund (SSgA Russell 3000 Fund) and the SSgA MSCI ACWI Ex USA Non-Lending Fund (SSgA MSCI ACWI Ex USA Fund) as follows (in thousands):

Fund name	Shares	Value
SSgA Russell 3000 Fund	7,288	\$ 160,370
SSgA MSCI ACWI Ex USA Fund	3,618	59,215
Total nonexchange commingled trust funds		\$ 219,585

The investment objective of the Russell 3000 Fund is to approximate as closely as practicable, before expenses, the performance of the Russell 3000 Index over the long term. Shares can be redeemed on a daily basis at NAV and have no redemption restrictions.

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The investment objective of the SSgA MSCI ACWI Ex USA Fund is to approximate as closely as practicable, before expenses, the performance of the MSCI ACWI ex USA Index over the long term. Shares can be redeemed semi-monthly at NAV and have no redemption restrictions.

As of June 30, 2016, the investments underlying the SSgA Russell 3000 Fund and the SSgA MSCI ACWI Ex USA Fund, had the following sector allocations:

Sector	SSgA Russell 3000 Fund	SSgA MSCI ACWI Ex USA Fund
Information technology	19 %	8 %
Financials	17	28
Healthcare	14	9
Consumer discretionary	13	12
Industrials	10	11
Consumer staples	9	10
Energy	7	7
Materials	4	7
Utilities	4	3
Telecommunication services	3	5
Total	<u>100 %</u>	<u>100 %</u>

(ii) *Investments in Limited Partnerships*

The fair value of investments in limited partnerships at June 30, 2016, amounted to approximately \$47 million. The allocations of net gains and losses to limited partners are based on certain percentages, as established in the limited partnership agreements. Investments in limited partnerships are not rated by a nationally recognized statistical rating organization.

In accordance with the partnership agreements, the System's investments can only be redeemed upon distribution from funds managers; usually in the form of a sale of its holdings or dividends distributed. As of June 30, 2016, the System does not intend to sell its investments in limited partnerships for an amount different to that presented in the financial statements.

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As of June 30, 2016, the date of commitment, total commitment, 2016 contributions, contributions to date at cost, and estimated fair value of investments in limited partnerships are as follows (in thousands):

	<u>Date of commitment</u>	<u>Total commitment</u>	<u>2016 Contributions</u>	<u>Contributions to date at cost</u>	<u>Estimated fair value</u>
Grupo Guayacán, Inc.-					
Guayacán Fund of Funds II, LP	August 1999	\$ 25,000	—	23,681	1,743
Advent-Morro Equity Partner, Inc.:					
Guayacán Private Equity Fund, LP	January 1997	5,000	—	4,645	2,161
Guayacán Private Equity Fund II, LP	April 2007	25,000	3,196	24,547	25,701
Venture Capital Fund, Inc.	November 1995	800	—	800	744
GF Capital Management and Advisors, LLC – GF Capital Private Equity Fund LP	December 2006	25,000	—	25,793	17,112
Chase Capital Partners Private: Equity Fund of Funds Corporate					
Martineau Bay Resort, s. en c. (s.e.)	July 1998	1,796	—	1,796	—
<b>Total</b>		<u>\$ 82,596</u>	<u>3,196</u>	<u>81,262</u>	<u>47,461</u>

(iii) *Securities Lending Transactions*

The System participates in a securities lending program, whereby securities are transferred to an independent broker or dealer in exchange for collateral in the form of cash, government securities, and/or irrevocable bank letters of credit with a simultaneous agreement to return the collateral for the same securities in the future. Collateral is marked to market daily and the agent places a request for additional collateral from brokers, if needed. The custodian bank is the agent for the securities lending program.

At the end of fiscal year 2016, there was no credit risk exposure to borrowers because the amounts the System owes the borrowers (the collateral) exceeded the amounts the borrowers owe the System (the securities lent). At June 30, 2016, the collateral received represented 103.8% of the fair value of the total securities lent.

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The securities on loan for which collateral was received as of June 30, 2016, consisted of the following (in thousands):

<u>Description</u>	<u>Fair value of underlying securities</u>
U.S. government securities:	
U.S. Treasury bills	\$ 110
U.S. Treasury notes	2,351
U.S. government sponsored agencies notes:	
U.S. corporate bonds and notes	14,634
Non U.S. corporate bonds and notes	<u>1,940</u>
Total	\$ <u>19,035</u>

The underlying collateral for these securities had a fair value of approximately \$19.8 million as of June 30, 2016. The collateral received was invested in a money market fund sponsored by the custodian bank. As of June 30, 2016, the short-term investment fund consisted of securities purchased under agreements to resell.

Under the terms of the securities lending agreement, the System is fully indemnified against failure of the borrowers to return the securities lent (to the extent the collateral is inadequate to replace the securities lent) or failure to pay the System for income distributions by the securities' issuers while the securities are on loan. In addition, the System is indemnified against loss should the lending agent fail to demand adequate and appropriate collateral on a timely basis.

**(7) Accounts Receivable from Employers**

As of June 30, 2016, accounts receivable from employers consisted of the following (in thousands):

Early retirement programs	\$ 2,733
Special laws	64,012
Employer and employee contributions	383,889
Interest on late payments	<u>59,001</u>
Total accounts receivable from employers	509,635
Less allowance for adjustments and losses in realization	<u>(250,834)</u>
Total accounts receivable from employers – net	\$ <u>258,801</u>

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Under Act No. 447, each employer must pay, on a monthly basis, the amounts corresponding to contributions and loan repayments, on or before the fifteenth day of the following month. After that date, interest is charged as established by the System.

As more fully described in note 3, the Commonwealth and many of its instrumentalities, which are the employers of the System, have been facing significant fiscal and economic challenges. Further, in recent months, the rating downgrade and widening of credit spreads for the Commonwealth's public sector and public corporations' debt has put further strain on liquidity and sources of funding of the employers. Consequently, most of the receivables from employers are delinquent past established payment dates and/or installment plan due dates. In other instances, amounts past due have continued to be renegotiated to later dates.

As of June 30, 2016, the System recorded an allowance of approximately \$251 million for adjustments and losses in realization of the additional uniform contributions due from the Commonwealth for the fiscal years 2015 and 2016 because, as explained in note 3, its collectability is currently uncertain.

Although certain measures have been implemented to improve the collection of such receivables, the timing of collections from employers affects the liquidity needs of the System. Management is of the opinion that, except for the additional uniform contributions of the Commonwealth of approximately \$251 million, other amounts due from employers are collectible; however, this situation could ultimately affect the payment of benefits to members or repayment of the System's bonds payable, should any such amounts become uncollectible in the future.

**(8) Member Loans and Interest Receivable**

Loans receivable from plan members are guaranteed by the contributions of plan members and by other sources, including mortgage deeds and any unrestricted amount remaining in the escrow funds. In addition, collections on loans receivable are received through payroll withholdings. The latest maximum amount of loans to plan members for mortgage loans was \$100,000 and \$5,000 for personal and cultural trip loans. The originations of mortgage loans were frozen in December 2013 and those related to personal and cultural loans were frozen in November 2016. During the years ended June 30, 2014 and 2013, personal loans with principal balances amounting to approximately \$100 million and \$88 million, respectively, were sold to two financial institutions. As per servicing agreements, the System is in charge of the servicing, administration and collection of the loans and outstanding principal balances at and after closing date for a servicing fee of 2%.

The allowance for adjustments and losses in realization is considered a general allowance for all categories of loans and interest receivable, except mortgage loans, and also a specific allowance for the special collection project loans balances.

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As of June 30, 2016, the composition of loans and interest receivable from plan members is summarized as follows (in thousands):

Loans receivable:	
Personal	\$ 350,651
Mortgage	169,658
Cultural trips	<u>45,289</u>
Total loans to plan members	565,598
Accrued interest receivable	34,177
Less allowance for adjustments and losses in realization	<u>(2,778)</u>
Total loans and interest receivable from plan members – net	<u>\$ 596,997</u>

**(9) Other Assets**

As of June 30, 2016, other assets mainly consist of repossessed and foreclosed properties acquired through foreclosure proceedings related to delinquent mortgage loans. Foreclosed properties are valued at the outstanding principal balance of the related mortgage loan upon foreclosure. These properties will be sold under a bidding process intended to recover the outstanding principal balance of the related mortgage loan. A gain or loss is recognized at the time of sale.

Differences resulting from the recognition of losses at the point of sale rather than upon foreclosure, as required by GAAP, are not material. Management believes that the carrying value of these properties approximates fair value.

**(10) Bonds Payable**

Senior Pension Funding Bonds – On February 27, 2007, the ERS and JRS Administration and GDB, acting as the System's cash fiscal agent (the Cash Fiscal Agent), presented to the System's Board, a financial transaction for the issuance of pension funding Bonds in order to reduce the System's unfunded actuarial accrued liability. The Bonds are limited, nonrecourse obligations of the System, payable solely from and secured solely by a pledge of employer contributions made after the date of issuance of the first series of Bonds, and from funds held on deposit with the Bank of New York Mellon, acting as the System's investments fiscal agent (the Investment Fiscal Agent). The Bonds are not payable from contributions made to the System by participating employees, or from the assets acquired with the proceeds of the Bonds, or from employer contributions released by the Cash Fiscal Agent to the System after funding of required reserves, or from any other assets of the System. The System invested the proceeds of the Bonds and used these investments and the earnings thereon to provide pension benefits to its beneficiaries.

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On January 31, 2008, the System issued the first series of Bonds, which consisted of approximately \$1,589 million aggregate principal amount of Senior Pension Funding Bonds, Series A (the Series A Bonds). On June 2, 2008, the System issued the second of such series of Bonds, which consisted of approximately \$1,059 million aggregate principal amount of Senior Pension Funding Bonds, Series B (the Series B Bonds). Finally, on June 30, 2008, the System issued the third and final of such series of Bonds, which consisted of approximately \$300 million aggregate principal amount of Senior Pension Funding Bonds, Series C (the Series C Bonds).

The following is a summary of changes in the Bonds payable principle balance (in thousands):

	<u>Maturity</u>	<u>Balance at June 30, 2015</u>	<u>Accretion</u>	<u>Balance at June 30, 2016</u>
5.85% to 6.45% Term and Capital Appreciation Bonds Series A	2023–2058	\$ 1,614,623	4,449	1,619,072
6.25% to 6.55% Term and Capital Appreciation Bonds Series B	2028–2058	1,195,722	24,563	1,220,285
6.15% to 6.50% Term and Capital Appreciation Bonds Series C	2028–2043	301,449	229	301,678
Bond discounts		<u>(6,346)</u>	<u>213</u>	<u>(6,133)</u>
Total		\$ <u>3,105,448</u>	<u>29,454</u>	<u>3,134,902</u>



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As of June 30, 2016, the outstanding principal balance of the Bonds is as follows (in thousands):

<u>Description</u>	
<b>Series A Bonds:</b>	
Capital Appreciation Bonds, maturing in 2028, bearing interest at 6.20%	\$ 75,302
Term Bonds, maturing in 2023, bearing interest at 5.85%	200,000
Term Bonds, maturing from 2031 through 2038, bearing interest at 6.15%	679,000
Term Bonds, maturing from 2039 through 2042, bearing interest at 6.20%	332,770
Term Bonds, maturing from 2055 through 2058, bearing interest at 6.45%	332,000
Total Series A Bonds outstanding	<u>1,619,072</u>
<b>Series B Bonds:</b>	
Capital Appreciation Bonds, maturing from 2028 through 2030, bearing interest at 6.40%	234,706
Capital Appreciation Bonds, maturing from 2031 through 2034, bearing interest at 6.45%	169,479
Term Bonds, maturing in 2031, bearing interest at 6.25%	117,100
Term Bonds, maturing from 2036 through 2039, bearing interest at 6.30%	270,000
Term Bonds, maturing from 2055 through 2058, bearing interest at 6.55%	429,000
Total Series B Bonds outstanding	<u>1,220,285</u>
<b>Series C Bonds:</b>	
Capital Appreciation Bonds, maturing in 2030, bearing interest at 6.50%	3,678
Term Bonds, maturing in 2028, bearing interest at 6.15%	110,000
Term Bonds, maturing in 2038, bearing interest at 6.25%	45,000
Term Bonds, maturing in 2043, bearing interest at 6.30%	143,000
Total Series C Bonds outstanding	<u>301,678</u>
Total bonds outstanding	3,141,035
Less bonds discount	<u>(6,133)</u>
Bonds payable – net	<u>\$ 3,134,902</u>

*Series A Bonds* – The aggregate principal amount of the Series A Bonds issued amounted to approximately \$1,589 million of which \$1,544 million were issued as term bonds (the Series A Term Bonds) and \$45 million were issued as capital appreciation bonds (the Series A Capital Appreciation Bonds). Interest in the Series A Term Bonds are payable monthly on the first day of each month. Interest on the Series A Capital Appreciation Bonds are not payable on a current basis but are added to the principal of the Capital Appreciation Bonds on each January 1 and July 1 (Compounding Dates), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360 day year consisting of twelve 30 day months.

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The Series A Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series A Capital Appreciation Bonds, the accreted amount) of the Series A Bonds, plus accrued interest to the redemption date, and without premium.

In addition, the following Series A Term Bonds are subject to mandatory redemption in part commencing on July 1, 2021 to the extent of the sinking fund requirement for said bonds set forth below at a redemption price equal to 100% of the principal amount thereof plus accrued interest as follows (in thousands):

Redemption period	Subject bonds	Amount
July 1, 2021	Term bonds (final maturity July 1, 2023)	\$ 50,000
July 1, 2022	Term bonds (final maturity July 1, 2023)	70,000
July 1, 2023	Term bonds (final maturity July 1, 2023)	80,000
	Subtotal	<u>200,000</u>
July 1, 2031	Term bonds (final maturity July 1, 2038)	3,000
July 1, 2032	Term bonds (final maturity July 1, 2038)	4,500
July 1, 2033	Term bonds (final maturity July 1, 2038)	4,000
July 1, 2034	Term bonds (final maturity July 1, 2038)	133,500
July 1, 2035	Term bonds (final maturity July 1, 2038)	133,500
July 1, 2036	Term bonds (final maturity July 1, 2038)	133,500
July 1, 2037	Term bonds (final maturity July 1, 2038)	133,500
July 1, 2038	Term bonds (final maturity July 1, 2038)	133,500
	Subtotal	<u>679,000</u>
Total		<u>\$ 879,000</u>

*Series B Bonds* – The aggregate principal amount of the Series B Bonds amounted to approximately \$1,059 million of which \$816 million were issued as term bonds (the Series B Term Bonds) and \$243 million were issued as capital appreciation bonds (the Series B Capital Appreciation Bonds). Interest in the Series B Term Bonds are payable monthly on the first day of each month. Interest on the Series B Capital Appreciation Bonds are not payable on a current basis but are added to the principal of the Series B Capital Appreciation Bonds on each January 1 and July 1 (Compounding Dates), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360 day year consisting of twelve 30 day months.

The Series B Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series B Capital Appreciation Bonds, the accreted amount) of the Series B Bonds, plus accrued interest to the redemption date, and without premium.

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*Series C Bonds* – The aggregate principal amount of the Series C Bonds amounted to approximately \$300 million of which \$298 million were issued as term bonds (the Series C Term Bonds) and \$2 million were issued as capital appreciation bonds (the Series C Capital Appreciation Bonds). Interest in the Series C Term Bonds are payable monthly on the first day of each month. Interest on the Series C Capital Appreciation Bonds are not payable on a current basis, but are added to the principal of the Series C Capital Appreciation Bonds on each January 1 and July 1 (Compounding Dates), and are treated as if accruing in equal daily amounts between Compounding Dates, until paid at maturity or upon redemption. Interest shall be computed on the basis of a 360 day year consisting of twelve 30 day months.

The Series C Bonds are subject to redemption at the option of the System from any source, in whole or in part at any time on or after July 1, 2018, at a redemption price equal to the principal amount (in the case of Series C Capital Appreciation Bonds, the accreted amount) of the Series C Bonds, plus accrued interest to the redemption date, and without premium.

In addition, the following Series C Term Bonds are subject to mandatory redemption in part commencing on July 1, 2024 to the extent of the sinking fund requirement for said bonds set forth below at a redemption price equal to 100% of the principal amount thereof plus accrued interest as follows (in thousands):

Redemption period	Subject bonds	Amount
July 1, 2024	Term bonds (final maturity July 1, 2028)	\$ 18,700
July 1, 2025	Term bonds (final maturity July 1, 2028)	22,000
July 1, 2026	Term bonds (final maturity July 1, 2028)	29,150
July 1, 2027	Term bonds (final maturity July 1, 2028)	36,300
July 1, 2028	Term bonds (final maturity July 1, 2028)	3,850
	Subtotal	110,000
July 1, 2029	Term bonds (final maturity July 1, 2038)	100
July 1, 2030	Term bonds (final maturity July 1, 2038)	540
July 1, 2031	Term bonds (final maturity July 1, 2038)	100
July 1, 2032	Term bonds (final maturity July 1, 2038)	3,420
July 1, 2033	Term bonds (final maturity July 1, 2038)	4,320
July 1, 2034	Term bonds (final maturity July 1, 2038)	100
July 1, 2035	Term bonds (final maturity July 1, 2038)	11,940
July 1, 2036	Term bonds (final maturity July 1, 2038)	2,160
July 1, 2037	Term bonds (final maturity July 1, 2038)	7,920
July 1, 2038	Term bonds (final maturity July 1, 2038)	14,400
	Subtotal	45,000

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<u>Redemption period</u>	<u>Subject bonds</u>	<u>Amount</u>
July 1, 2039	Term bonds (final maturity July 1, 2043)	\$ 28,600
July 1, 2040	Term bonds (final maturity July 1, 2043)	28,600
July 1, 2041	Term bonds (final maturity July 1, 2043)	28,600
July 1, 2042	Term bonds (final maturity July 1, 2043)	28,600
July 1, 2043	Term bonds (final maturity July 1, 2043)	28,600
		<u>143,000</u>
Total		<u>\$ 298,000</u>

Debt service requirements in future years on the System's Bonds as of June 30, 2016 are as follows (in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2017	\$ —	166,519	166,519
2018	—	166,519	166,519
2019	—	166,519	166,519
2020	—	166,519	166,519
2021	—	166,519	166,519
2022–2026	200,000	797,495	997,495
2027–2031	808,280	753,800	1,562,080
2032–2036	613,560	739,532	1,353,092
2037–2041	1,240,170	520,143	1,760,313
2042–2046	218,100	305,430	523,530
2047–2051	—	285,084	285,084
2052–2056	183,200	273,171	456,371
2057–2061	577,800	77,838	655,638
	<u>3,841,110</u>	<u>\$ 4,585,088</u>	<u>8,426,198</u>
Less:			
Unaccreted interest	(700,075)		
Unamortized discount	<u>(6,133)</u>		
Total	<u>\$ 3,134,902</u>		

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*Pledge of Employer Contributions Pursuant to Security Agreement* – The System entered into a Security Agreement with the Fiscal Agent for the benefit of the bondholders, pursuant to which the System pledged to the Fiscal Agent, and granted the Fiscal Agent a security interest in employer contributions made after January 31, 2008, which was the date of issuance of the first series of bonds, and the funds on deposit with the Fiscal Agent under the various accounts established under the Pension Funding Bond Resolution (the Resolution).

The Resolution and the Security Agreement constitute a contract between the System and the Fiscal Agent, on behalf of the owners of the bonds. The pledge, covenants and agreements of the System set forth in the Resolution and the Security Agreement shall be for the equal benefit, protection and security of the owners of the bonds, regardless of time or times of their issuance or maturity, and shall be of equal rank, without preference, priority or distinction of any of the bonds over any other bond, except as expressly provided in or permitted by the Resolution. Annual employer contributions that are made after January 31, 2008, which was the date of issuance of the first series of bonds, in accordance with the Act and amounts on deposit in the different accounts created pursuant to the Resolution for the benefits of the owners of the bonds, are pledged for annual debt service requirements as established. The pledge is irrevocable so long as any bonds are outstanding under the terms of the Resolution.

Starting in August 2016, and monthly thereafter, the fiscal agent under the Resolution of the System's bonds notified to the System that it failed to transfer the requisite employers' contributions on the last business day of each month. The fiscal agent is not seeking to collect or recover any indebtedness from, enforce any judgment against, or obtain possession of, exercise control over, any property of or from, the Commonwealth or any of its instrumentalities, including the System, or exercise any act that is stayed by PROMESA, the Puerto Rico Financial Emergency and Fiscal Responsibility Act of January 29, 2017 (Act No. 5 or the Financial Emergency Act), the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act of April 6, 2016 (Act No. 21 or the Moratorium Act), or any Executive Orders related thereto. Consistent with PROMESA, the Financial Emergency Act, the Moratorium Act, and any Executive Orders, the fiscal agent is not exercising at this time any rights or remedies against the Commonwealth of Puerto Rico or any of its instrumentalities, including the System.

**(11) Guarantee Insurance Reserve for Member Loans**

The System provides life insurance that guarantees the payment of the outstanding principal balance of mortgage, personal and cultural trip loans in case of death of a plan member. The plan members who obtained these loans from the System pay the coverage in its entirety. The life insurance rates are actuarially determined and do not vary by age, sex, or health status.

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**(12) Other Postemployment Healthcare Benefits Funded Status and Funding Progress**

The System's other postemployment healthcare benefits (OPEB) funded status as of June 30, 2016, the most recent actuarial valuation date, is as follows (dollars in thousands):

Actuarial value of plan assets	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability (UAAL)	Funded ratio	Annual covered payroll	UAAL as a percentage of annual covered payroll
\$ —	1,349,503	1,349,503	— %	\$ 3,344,382	40.4 %

The schedule of funding progress, presented as required supplementary information following the notes to the basic financial statements, presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the AAL for benefits.

Act No. 3 eliminated the medical insurance plan contribution of \$100 per month for future retirees effective July 1, 2013.

The census data collection date is at beginning-of-year. The liability results as of June 30, 2016 are based on projecting the System obligations determined as of the census data collection date of July 1, 2015 for one year, using roll-forward methods and assuming no liability gains or losses. The amortization period for GASB Statement No. 45 has been reduced to the expected future lifetime of current in pay members.

The actuarial valuations used the following actuarial assumptions:

Actuarial cost method	Entry age normal
Amortization method	18 years closed (beginning July 1, 2014), level dollar
Remaining amortization period	18 years
Asset valuation method	Not applicable
Actuarial assumptions:	
Investment rate of return	3.10%
Projected salary increases	Not applicable
Projected payroll growth	Not applicable
Inflation	Not applicable
Cost of living adjustment	Not applicable

Actuarial valuations of an ongoing plan involve estimates of the net value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment and mortality. Amounts determined are subject to continuous revision as actual results are compared with past expectations and new estimates are made about the future.

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Calculations are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation and on the pattern of sharing of costs between the employer and plan members to that point. The projection of OPEB for financial reporting purposes does not explicitly incorporate the potential effects of legal or contractual funding limitations on the pattern of cost sharing between the employer and plan members in the future.

The actuarial calculations reflect a long-term perspective. Consistent with that perspective, actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and actuarial value of assets.

The OPEB mortality rate assumptions are the same as that for pension benefits. For additional information refer to note 5.

**(13) Contingencies**

**A. Litigation Filed by Creditors Against the System Prior to Commencement of the Title III Cases**

The System is a defendant in a lawsuit brought by pensioners of the System. They filed the claim on behalf of the System against the underwriters of certain pension bonds of the System and some of the former members of the Board of Trustees of the System. The complaint requested \$800 million in damages resulting from the \$3 billion bond issuance in 2008 that, according to the plaintiffs, compromised the solvency of the System. In December, 2016, the Court of First Instance permitted the transpose of the System as plaintiff in the Complaint.

**B. Litigation Filed by Creditors Against the System After Commencement of the Title III Cases**

*Employees Ret. Sys. of the Gov't of the Commonwealth of Puerto Rico, et al. v. Altair Global Credit Opportunities Fund (A), LLC, et al.*, Adv. Pro. No. 17-00213 (D.P.R. July 21, 2017)

On July 21, 2017, the System commenced an adversary proceeding challenging the System bondholders' security interests in various System assets through a declaratory relief action (the System Adequate Protection Suit). The System contends the System bondholders' security interests are not perfected because their financing statements do not adequately describe the collateral, and the System bondholders' attempts in 2015 and 2016 to correct the deficient statements through amendments were defective. The System also challenges among other things, the defendants' alleged security interest in post-petition employer contributions.

On August 17, 2018, the Title III court granted partial summary judgment in favor of the System. The Title III court held, among other things, that the System bondholders' liens are not perfected, their security interests are avoidable under Bankruptcy Code section 544, and their claims will be treated as general unsecured claims.

*Altair Global Credit Opp. Fund (A), LLC, et al. v. Commonwealth of Puerto Rico, et al.*, Adv. Pro. Nos. 17-00219-LTS, 17-00220-LTS (D.P.R. July 27, 2017)

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On July 27, 2017, a group of System bondholders commenced adversary proceedings (collectively, the PayGo Litigation) against the Commonwealth and the System seeking a declaration that Joint Resolution 188 and Act No. 106 (collectively, the PayGo Statute) – which requires the System to liquidate its assets for distribution to the General Fund – is void *ab initio* as a violation of the Title III automatic stay and violates the Contracts Clause and Takings Clause of the U.S. Constitution.

On November 17, 2017, the Oversight Board (joined by FAFAA and the Retiree Committee) filed a motion to dismiss the PayGo Litigation. On February 2, 2018, the Title III court issued an order informing the parties that the motion to dismiss would be taken under submission. As of the date hereof, the Title III court has not issued an opinion on the Oversight Board's motion to dismiss.

In addition, the System is a defendant or co-defendant in various lawsuits resulting from the ordinary conduct of its operations. Based on the advice of legal counsel and considering insurance coverages, management is of the opinion that the ultimate liability, if any, will not have a significant effect on the financial status of the System.

**(14) Subsequent Events**

Subsequent events were evaluated through October 5, 2018 to determine if any such events should either be recognized or disclosed in the 2016 basic financial statements. The subsequent events disclosed below are principally those related to debt activities, including credit rating downgrade events and other related fiscal events, and related legislation, both local and federal, that management believes are of public interest for disclosure.

**A. Puerto Rico Oversight, Management, and Economic Stability Act**

On June 30, 2016, the President of the United States signed PROMESA into law (as codified under 48 U.S.C. §§ 2101-2241). In general terms, PROMESA seeks to provide the Commonwealth and its covered instrumentalities with fiscal and economic discipline through, among other things: (i) the establishment of the Oversight Board, whose responsibilities include the certification of fiscal plans and budgets for the Commonwealth and its related entities; (ii) a temporary stay of all creditor lawsuits under Title IV of PROMESA, which expired on May 1, 2017; and (iii) two alternative methods to adjust unsustainable debt: (a) a voluntary debt modification process under Title VI of PROMESA, which establishes a largely out-of-court debt restructuring process through which modifications to financial debt can be accepted by a supermajority of creditors; and (b) a quasi-bankruptcy proceeding under Title III of PROMESA, which establishes an in-court debt restructuring process substantially based upon incorporated provisions of the U.S. Bankruptcy Code (11 U.S.C. §§ 101, *et seq.*).

Title III of PROMESA establishes an in-court process for restructuring the debts of Puerto Rico and other United States territories that is modeled after the process under Chapter 9 of the U.S. Bankruptcy Code. In order to be a debtor under Title III, the territory and/or its instrumentalities must: (i) have an Oversight Board established for it or be designated a "covered entity"; (ii) have the Oversight Board issue a restructuring certification under PROMESA section 206(b); and (iii) "desire to effect a plan to adjust its debt." PROMESA § 302. The Oversight Board has sole authority to file a voluntary petition seeking protection under Title III of PROMESA. See PROMESA § 304(a).



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In a Title III case, the Oversight Board acts as the debtor's representative and is authorized to take any actions necessary to prosecute the Title III case. See PROMESA § 315. Immediately upon filing the Title III petition, Bankruptcy Code section 362 (which is incorporated into Title III cases under PROMESA) applies to automatically stay substantially all litigation against the debtor (the Title III Stay). After the Title III case is commenced, the Chief Justice of the United States Supreme Court must designate a district court judge to sit by designation and preside over the Title III proceedings. PROMESA also provides that the commencement of a Title III case "does not limit or impair the powers of a covered territory to control by legislation or otherwise the exercise of the political or governmental powers of the territory or territorial instrumentality." PROMESA § 303.

The core component of the Title III case is the confirmation of a plan of adjustment of the debts of the debtor. The Oversight Board has the exclusive authority to file and modify a plan of adjustment prior to confirmation. See PROMESA § 312. In order to be confirmed, a proposed plan of adjustment must meet the requirements set forth under PROMESA section 314.

Title IV of PROMESA contains several miscellaneous provisions, including a temporary stay of litigation related to "Liability Claims," relief from certain wage and hour laws, the establishment of a Congressional Task Force on Economic Growth in Puerto Rico (the Task Force), the requirement that the Comptroller General of the United States submit two reports to Congress regarding the public debt levels of the U.S. territories, and expansion of the federal government's small business HUBZone program in Puerto Rico.

Pursuant to PROMESA section 405, the enactment of PROMESA immediately and automatically imposed a temporary stay (the Title IV Stay) from June 30, 2016 (the date of PROMESA's enactment) through February 15, 2017 of all "Liability Claim" litigation commenced against the government of Puerto Rico and its instrumentalities after December 18, 2015. See PROMESA § 405(d)(1)(A). A "Liability Claim" is defined as any right to payment or equitable remedy for breach of performance related to "a bond, loan, letter of credit, other borrowing title, obligation of insurance, or other financial indebtedness for borrowed money, including rights, entitlements, or obligations whether such rights entitlements, or obligations arise from contract, statute, or any other source of law related [thereto]" for which the Commonwealth or one of its instrumentalities was the issuer, obligor, or guarantor and such liabilities were incurred prior to June 30, 2016. PROMESA § 405(a)-(b). The Title IV Stay was subject to a one-time 75-day extension by the Oversight Board or a one-time 60-day extension by the district court. On January 28, 2017, the Oversight Board extended the stay by 75 days to May 1, 2017, at which time the Title IV Stay expired. Any party subject to the Title IV Stay could have filed a motion in the United States District Court for the District of Puerto Rico seeking a relief from the Title IV Stay upon "cause shown." PROMESA § 405(e).

**B. Oversight Board Commencement of Title III Cases**

On May 1, 2017, the Title IV Stay expired, permitting the substantial litigation brought by bondholders and other creditors against the Commonwealth and its instrumentalities to resume. On May 3, 2017, the Oversight Board commenced a Title III case at the request of the Commonwealth by filing a petition for relief under Title III of PROMESA in the United States District Court for the District of Puerto Rico. On May 5, 2017, the Oversight Board commenced a Title III case at the request of COFINA by filing a

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similar petition for relief under Title III of PROMESA. On May 11, 2017, United States Supreme Court Chief Justice John Roberts designated United States District Judge Laura Taylor Swain as the presiding judge in the Title III cases.

On May 21, 2017, the Oversight Board commenced Title III cases at the request of the System and Puerto Rico Highways and Transportation Authority (PRHTA) by filing similar petitions for relief under Title III of PROMESA. On July 3, 2017, the Oversight Board commenced a Title III case at the request of Puerto Rico Electric Power Authority (PREPA) by filing a similar petition for relief under Title III of PROMESA. All of the foregoing Title III cases have been consolidated for procedural purposes only and are being jointly administered under Case No. 17-3283-LTS in the United States District Court for the District of Puerto Rico. On June 15, 2017, the United States Trustee appointed an Official Committee of Retired Employees (the Retiree Committee) in the consolidated Title III cases.

The Title III cases were commenced in part due to the May 1, 2017 expiration of the Title IV Stay. Title III of PROMESA incorporates the automatic stay provisions of Bankruptcy Code section 362 and 922, which are made applicable to the Title III cases pursuant to PROMESA section 301(a). Accordingly, upon the filing of the Title III cases, the Title III Stay immediately went into effect to stay creditor litigation.

**C. Key Contested Motions in the Title III Cases**

On July 17, 2017, the Title III court entered an order approving an agreement (the Joint Stipulation) between the System and certain System bondholders. In the Joint Stipulation, the parties agreed that the System would make interest payments due on October 1, 2017 from the System's Prepetition Segregated Account (which was created pursuant to a stipulation and order dated January 17, 2017) and that these payments would constitute adequate protection for the System bondholders until October 31, 2017 with respect to the Title III stay.

On November 28, 2017, a group of System bondholders filed a motion in the System's Title III case, which requires the System to continue making current monthly interest payments to System bondholders pending resolution of the summary judgment motions in the System Adequate Protection Suit. After a hearing held on December 20, 2017, the Title III court issued a brief oral opinion requiring the System to make monthly interest payments to the System bondholders from a Prepetition Segregated Account pursuant to the Joint Stipulation until the earlier of (i) the Title III court issues a summary judgment ruling in the System Adequate Protection Suit or (ii) the exhaustion of the funds in the Prepetition Segregated Account.

On July 3, 2018, a group of System bondholders filed a motion in the System's Title III case (the System Bondholders' Stay Relief Motion) arguing that the Prepetition Segregated Account was expected to run out of funds in August 2018, depriving System bondholders of adequate protection in the form of monthly interest payments and therefore leaving the System bondholders' constitutionally protected property interests unprotected. The System bondholders assert that relief from the Title III stay is needed in order to maintain the status quo pending the Title III court's resolution of the cross-motions for summary judgment in the System Adequate Protection Suit. In the alternative, the

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System bondholders requested adequate protection of their liens on property of the System, in which the Commonwealth now claims an interest.

As discussed in note 13, on August 17, 2018, the Title III court held in the System Adequate Protection Suit that the System bondholders' liens are not perfected, their security interests are avoidable under Bankruptcy Code section 544, and their claims will be treated as general unsecured claims. On August 21, 2018, the Title III court entered an order to that effect by denying the System Bondholders' Stay Relief Motion.

**D. Puerto Rico Emergency Moratorium and Financial Rehabilitation Act, Puerto Rico Fiscal Responsibility and Financial Emergency Act and Related Executive Orders**

Pursuant to the Moratorium Act, the Governor issued a series of executive orders declaring an emergency period, a moratorium and various other measures with respect to certain obligations of the Commonwealth and several of its instrumentalities, including the System. Pursuant to these executive orders, certain Commonwealth entities have either: (i) not made debt service payments, (ii) made debt service payments with funds on deposit with the trustees of their bonds, and/or (iii) not received or transferred certain revenues. Such executive orders also placed significant restrictions on the disbursement of funds deposited at GDB and suspended the disbursement of loans by GDB. These executive orders restricted the System's ability to withdraw any funds held on deposit at GDB and to receive any disbursements on loans granted by GDB. These executive orders also suspended the obligation of the Commonwealth to transfer certain revenues previously allocated to the System.

Act No. 5 repealed certain provisions of the Moratorium Act and authorized additional emergency measures. Pursuant to Act No. 5, however, the executive orders issued under the Moratorium Act would continue in effect until amended, rescinded or superseded. The emergency period under Act No. 5 will expire December 31, 2018, unless extended by the Governor. Some additional powers provided to the Governor through Act No. 5 include the authority to: (i) exercise receivership powers to rectify the financial emergency, (ii) exercise general supervisory control over the functions and activities of all government entities within the Executive Branch, and (iii) issue executive orders to implement and enforce compliance with Act No. 5.

**E. Sale of System Investments**

On June 23, 2017, the Legislative Assembly approved certain other assignments for fiscal year 2018 under Joint Resolution 188, which among other things, ordered the System, JRS, and TRS to liquidate their assets and pass the net proceeds to the Treasury Department. On July 20, 2017, the System sold investments in the total aggregate amount of approximately \$297 million.

**F. PayGo Pension Reform**

On June 27, 2017, the Treasury Department issued Circular Letter No. 1300-46-17 in order to convey to the central government agencies, public corporations and municipalities the new implementation procedures to adopt, effective July 1, 2017, a new "pay-as-you-go" (PayGo) mechanism for the System.

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Subsequently, on August 23, 2017, the Governor signed into law the "Act to Guarantee the Payment to Our Pensioners and Establish a New Plan for Defined Contributions for Public Servants" (Act No. 106), which reformed the Commonwealth Retirement Systems. Act No. 106 terminated the previously existing pension programs for the System's participants as of June 30, 2017. The members of the prior programs and new system members hired on and after July 1, 2017 are now enrolled in a new defined contributions program. Act No. 106 also established by law the PayGo mechanism for the payment of accumulated pension benefits and eliminated employers' contributions and other analogous contributions. Approximately \$2 billion was allocated for the payment of PayGo benefits in each of the budgets for fiscal year 2018 and fiscal year 2019.

Furthermore, Act No. 106 modified the System's governance. Under Act No. 106, the System's Board of Trustees was substituted with a new Retirement Board, which is currently responsible for governing all of the Commonwealth's Retirement Systems.

Act No. 106 also ordered a suspension of the System's loan programs and ordered a merger of the administrative structures of the retirement systems. At the Retirement Board's discretion, the servicing of the System's existing loan portfolio may be externalized. Pursuant to Act No. 106, the employees of the System that are not retained under the new administrative structure will be transferred to other public agencies in conformity with Act No. 8 of February 8, 2017.

For additional information regarding litigation related to Act No. 106 and the PayGo system, refer to note 13.

**G. Bonds Credit Rating Downgrades**

On June 24, 2016, Fitch Ratings Inc. downgraded the System's Bonds from "CC" to "C" and placed them on "negative" outlook. Fitch cited "the breakdown of negotiations between the Commonwealth and major bondholders, the recent ruling by the U.S. Supreme Court on the Commonwealth's bankruptcy legislation, and the slow process of federal legislation in support of the Commonwealth" as indicators that a debt restructuring, deferral or default has become inevitable. On April 5, 2017, Moody's Investors Service downgraded the System's Bonds to from "C" to "Ca" and placed them on "negative" outlook, citing "persistent pressures on Puerto Rico's economic base that indicate a diminishing perceived capacity to repay." Standard & Poor's Ratings Services currently rates the System's Bonds at "CC."

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**H. Impact of Hurricanes Irma and Maria**

On September 20, 2017, Hurricane Maria made landfall in Puerto Rico. As a result of Hurricane Maria, the System's headquarters suffered major damages. In order to continue operations, the System had to relocate its offices and entered into a lease agreement with the Puerto Rico Public Buildings Authority. As a result of the relocation, the System eliminated certain of its prior contracts related to auxiliary services and negotiated new ones. As of the date hereof, management is in the process of determining the extent of damages from the hurricanes.

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Schedule of Changes in the Employers' Net Pension Liability and Related Ratios –  
Pension Benefits (Unaudited)

Years ended June 30, 2016 and 2015

(Dollars in thousands)

	<u>2016</u> <u>Amount</u>	<u>2015</u> <u>Amount</u>
Total pension liability:		
Service cost	\$ 496,732	425,564
Interest	1,230,843	1,279,556
Differences between expected and annual experience	(252,405)	(463,898)
Changes in assumptions	3,853,693	2,781,098
Benefit payments, including refunds of contributions	<u>(1,565,152)</u>	<u>(1,572,675)</u>
Net change in total pension liability	3,763,711	2,449,645
Total pension liability – beginning	<u>32,669,162</u>	<u>30,219,517</u>
Total pension liability – ending (a)	<u>36,432,873</u>	<u>32,669,162</u>
Plan's fiduciary net position (deficit):		
Employer contributions – net of provision	779,477	673,926
Member contributions	333,633	339,650
Net investment income	870	29,258
Other income	110,201	28,499
Benefit payments, including refunds of member contributions	(1,565,152)	(1,572,675)
Administrative expenses	(27,670)	(33,623)
Interest on bonds payable	(196,211)	(194,400)
Other expenses	<u>(32,761)</u>	<u>(19,573)</u>
Net change in plan fiduciary net position	(597,613)	(748,938)
Total fiduciary net position – beginning	<u>(668,272)</u>	<u>80,666</u>
Total fiduciary net position (deficit)– ending (b)	<u>(1,265,885)</u>	<u>(668,272)</u>
Employers' net pension liability – ending (a)-(b)	\$ <u>37,698,758</u>	<u>33,337,434</u>
Plan's fiduciary net position (deficit) as a percentage of the total pension liability	(3.47)%	(2.05)%
Covered employee payroll	\$ 3,344,382	3,319,280
Employers' net pension liability as a percentage of covered employee payroll	1,127.23 %	1,004.36 %

Note: Schedule is intended to show information for ten years. Additional years will be displayed as they become available.

See accompanying notes to required supplementary information and independent auditors' report.

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Schedule of Investment Return – Pension Benefits (Unaudited)

Years ended June 30, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Annual money-weighted rate of return, net of investment expenses	6.7 %	4.2 %

Note: Schedule is intended to show information for ten years. Additional years will be displayed as they become available.

See accompanying notes to required supplementary information and independent auditors' report.

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**Schedule of Employers' Contributions – OPEB (Unaudited)**

(Dollars in thousands)

<b>Fiscal year ended (1)</b>	<b>Annual required contributions</b>	<b>Actual employers' contributions</b>	<b>Percentage of contribution</b>
June 30, 2016	\$ 107,739	93,728	87.0
June 30, 2015	103,878	97,374	93.7
June 30, 2014	88,508	102,085	115.3
June 30, 2013	154,999	91,823	59.2
June 30, 2012	133,654	94,664	70.8
June 30, 2011	129,395	93,851	72.5
June 30, 2010	128,294	88,599	69.1

- (1) The System's annual required contributions for the year ended June 30, 2016 and 2015 were determined by the actuarial valuation at beginning of year that was updated to roll forward the funded status to June 30, 2016 and 2015 and assuming no liability gains or losses. Prior year actuarial valuations were made using end-of-year census data.

See accompanying notes to required supplementary information and independent auditors' report.



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**Schedule of Funding Progress – OPEB (Unaudited)**

(Dollars in thousands)

<b>Actuarial valuation date (1)</b>	<b>Actuarial value of plan assets</b>	<b>Actuarial accrued liability (AAL)</b>	<b>Unfunded Actuarial accrued liability (UAAL)</b>	<b>Funded ratio</b>	<b>Annual covered payroll</b>	<b>UAAL percentage of annual covered payroll</b>
June 30, 2016	\$ —	1,349,503	1,349,503	— %	\$ 3,344,382	40.4 %
June 30, 2015	—	1,428,788	1,428,788	—	3,319,280	43.0
June 30, 2014	—	1,438,475	1,438,475	—	3,489,096	41.2
June 30, 2013	—	1,482,879	1,482,879	—	3,489,096	42.5
June 30, 2012	—	2,120,970	2,120,970	—	3,570,339	59.4
June 30, 2011	—	1,758,389	1,758,389	—	3,666,402	48.0
June 30, 2010	—	1,699,373	1,699,373	—	3,818,332	44.5

- (1) The System's OPEB funded status as of June 30, 2016 and 2015 were determined by the actuarial valuation at beginning of year that was updated to roll forward the funded status to June 30, 2016 and 2015 and assuming no liability gains or losses. Prior year actuarial valuations were made using end-of-year census data.

See accompanying notes to required supplementary information and independent auditors' report.

## **REQUIRED SUPPLEMENTARY INFORMATION**

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**(1) Changes in Benefits Terms**

There have not been any changes in plan provisions since the prior valuation.

**(2) Changes in Assumptions**

Actuarial assumptions are revised periodically to more closely reflect actual, as well as anticipated future experience.

In fiscal years 2016 and 2015, the investment return assumption is 6.55% for both years. Accordingly, the assumed investment return on the defined contribution hybrid account (80% of the net investment return assumption) for fiscal years 2016 and 2015 is 5.24% for both years.

The projected mortality improvement scale was updated from Scale MP-2015 to Scale MP-2016, which was published by the Society of Actuaries in October 2016. Also, as Scale MP-2015 is a two-dimensional mortality scale, the base mortality rates for the post-retirement mortality assumption were set to the 2010 rates – the central year of the 2007 to 2012 System experience study upon which the rates were based. In addition, the pre-retirement mortality rates were also updated to reflect updated mortality tables published by the Society of Actuaries.

The asset basis for the date of depletion projection is the System's fiduciary net position (the gross assets plus deferred outflows of resources less the gross liabilities, including the senior pension funding bonds payable, plus deferred inflows of resources). On this basis, the System's fiduciary net position was exhausted in the fiscal year 2015.

In addition, the date of depletion projection of the actuarial report does not include any amounts from the additional uniform contribution required by Act No. 32 because of actual fiscal and budgetary financial difficulties with continued budget deficits and liquidity risks of the Commonwealth and the municipalities and in the event that their financial condition does not improve in the near term.

The System's fiduciary net position was not projected to be available to make all projected future benefit payments of current active and inactive employees. Therefore, the tax free municipal bond index (Bond Buyer General Obligation 20-Bond Municipal Bond Index) was applied to all periods of projected benefits payments to determine the total pension liability.

The discount rate used to determine the total pension liability decreased from 3.80% at June 30, 2015 to 2.85% at June 30, 2016, determined under GASB Statement No. 67. The discount rate used at June 30, 2014 was 4.29%. Under GASB Statement No. 67, the investment return assumption is an input that is used in the calculation of the single equivalent interest rate that is used to discount these benefits to determine the Total Pension Liability. Under former GASB Statements No. 25 and No. 27, the investment return assumption was used to discount all projected Basic System Pension Benefits and System Administered Pension Benefits to determine the Actuarial Accrued Liability. For fiscal years 2008 to 2010 and for fiscal years 2011, 2012 and 2013, the discount rates determined under GASB Statements No. 25 and No. 27 were 7.50%, 6.40%, 6.00% and 6.40%, respectively.

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Also, the valuations for fiscal year 2016 and 2015 reflect a salary freeze until July 1, 2017 due to Act No. 66 and the current economic conditions in Puerto Rico.

**(3) Changes in Actuarial Methods since the prior Valuation**

There have not been any changes in methods since the prior valuation.

In fiscal years 2016 and 2015, the census data collection date is as of beginning-of-year. The total pension liability at end of year was determined by actuarial valuation as of the census data collection date at beginning-of-year and was then projected forward to end-of-year, using roll-forward methods and assuming no liability gains or losses.

The June 30, 2016, actuarial valuation reflects an increase of \$4,361 million in the net pension liability as a result of the changes in assumptions of \$3,854 million, mainly related to the decrease in the discount rate as required by GASB Statement No. 67 from 3.80% in fiscal year 2015 to 2.85% in fiscal year 2016 and the Plan Fiduciary Net Deficit Position of approximately \$1,266 million as of June 30, 2016.

**(4) Method and Assumptions Used in the System's Actuarial Valuation**

The following actuarial methods and assumptions were used in the System's actuarial valuation of June 30, 2016:

Actuarial cost method	Entry age normal
Asset valuation method	Market value of assets
Inflation	2.50%
Municipal bond index	2.85%, as per Bond Buyer General Obligation 20-Bond Municipal Bond Index
Projected salary increases	3.00% per year. No compensation increases are assumed until July 1, 2021 as a result of Act No. 3 of 2017, four year extension of the Act 66-2014 and the current general economy.

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**Mortality**

**Pre-retirement Mortality:**

For general employees not covered under Act No. 127, RP-2014 Employee Mortality Rates for males and females adjusted to reflect Mortality Improvement Scale MP-2016 from the 2006 base year, and projected forward using MP-2016 on generational basis. For members covered under Act No. 127, RP-2014 Employee Mortality Rates with blue collar adjustments for males and females adjusted to reflect Mortality Improvement Scale MP-2016 from the 2006 base year, and projected forward using MP-2016 on generational basis. As generational tables, they reflect mortality improvements both before and after the measurement date. 100% of deaths while in active service are assumed to be occupational for members covered under Act No. 127.

**Post-retirement Healthy Mortality:**

Rates which vary by gender are assumed for healthy retirees and beneficiaries based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 92% of the rates from the UP-1994 Mortality Table for Males and 95% of the rates from the UP-1994 Mortality Table for Females, both projected from 1994 to 2010 using Scale AA. The base rates are projected using Mortality Improvement Scale MP-2016 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.

**Post-retirement Disabled Mortality:**

Rates which vary by gender are assumed for disabled retirees based on a study of plan's experience from 2007 to 2012 and updated expectations regarding future mortality improvement. The 2010 base rates are equal to 105% of the rates from the UP-1994 Mortality Table for Males and 115% of the rates from the UP-1994 Mortality Table for Females. The base rates are projected using Mortality Improvement Scale MP-2016 on a generational basis. As a generational table, it reflects mortality improvements both before and after the measurement date.